H.R. 660, SMALL BUSINESS CREDIT AVAILABILITY ACT OF 1993

HEARINGS

BEFORE THE

COMMITTEE ON SMALL BUSINESS HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

WASHINGTON, DC, FEBRUARY 4, MAY 6 AND 12, 1993

Printed for the use of the Committee on Small Business

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H.R. 660, SMALL BUSINESS CREDIT AVAILABILITY ACT OF 1993

THURSDAY, FEBRUARY 4, 1993

House of Representatives,
Committee on Small Business,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m., in room 2359-A, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the committee) presiding.

Chairman LaFalce. Today, the Small Business Committee commences hearings on H.R. 660, the Small Business Credit Availability Act of 1993. This is the first of what will be a series of hearings on this issue.

H.R. 660 is an attempt to match up the financial needs of the small business community for long-term, fixed-rate loans with investors, and it would be done without the need for long-term Government assistance.

During last year's Presidential campaign, President Clinton recommended that we "explore new ways to securitize bank loans to small businesses into debt securities that can be sold in secondary markets with techniques like those used for home mortgages and other asset-backed securities."

More recently, the President's nominee for chairperson of the Council of Economic Advisors, Laura D'Andrea Tyson, testified that we should look very carefully at securitization of small business loans, and this is what the Venture Enhancement and Loan Development Administration for Smaller Undercapitalized Enterprises, better known as Velda Sue, is all about—packaging of bank loans to small businesses as collateral for securities sold to the public. Going back almost a decade, I have advocated and introduced legislation in every Congress to establish just such a mechanism.

For years, the Congress has expressed its support for the small businesses of our Nation, and we have pointed with pride to the loan guarantee programs administered by the Small Business Administration.

But the Government cannot be expected to, nor can it appropriate sufficient funds, to provide all the loan guarantees it would like to small businesses. Yes, SBA's loan program is very, very important, and certainly should be continued, and certainly should be expanded, but, as many members know, the loan demand is well beyond our reach. It would be preferable if those loans could be

given without recourse to Government loan quarters in each and every instance.

The program that now exists, the 7(a) Program, closed once in December and would be closed again today were it not for the fact that President Clinton permitted the agency to borrow from loan guarantee authority reserved for use later this year. This borrowing will permit the program to continue, but only pending enactment of a supplemental appropriation. Of course, this is not the best way to run a railroad. We must have greater stability in financing small businesses.

An often-repeated story is that of a reporter who asked Willie Sutton why he robbed banks. His response was because that is where the money is.

Well, today there is a considerable amount of money in banks, but it is also in pension funds. It is also in the hands of insurance companies. It is also in the hands of institutional investors and private citizens, and these groups all have one thing in common: They invest in securities.

Money center banks are no longer major sources of loans for the small business community. Very often, although individual banks will deny this, very often their loan windows have been closed to small businesses. In fact, most major banks don't substantially participate in the SBA Loan Guarantee Program. We will undoubtedly hear of exceptions today.

For the most part, it is smaller, community-type banks which are making small business loans through the SBA. Many things can and should be done to change our banking laws to eliminate the disincentives that we have imposed upon lenders to provide loan money to the small business community, and I hope we will proceed to do that. I have outlined a great many of those ways in communications I have had with the new administration. At the same time, we can establish a mechanism to match up the investing community with small businesses that need financial assistance. We need not establish a new delivery system. We should use the existing delivery system—the existing network of banks, savings and loans, and other lenders and their expertise.

I believe that Velda Sue can provide this mechanism. It can encourage and facilitate the standardization of certain types of small business loans and allow us to match up small businesses with investors who have available funds. Of course, providing this type of standardization is key, and the private sector probably could develop the secondary market on its own if it weren't for the unique problems in developing standardization of small business loans. This is why, in my judgment, you need at least to start the program off a Government-sponsored enterprise. Perhaps, once the market is established and the standardization is achieved, it can go out of existence.

Perhaps this can be built into the law. But it hasn't developed on its own, and the need is great. The task of establishing this program is a large one. It is not going to be easy. But that doesn't mean it is not worth the effort, and that doesn't mean we shouldn't begin considering it immediately. Fannie Mae and Freddie Mac are good role models. They did not come into being overnight. Their de-

velopment took time, and I would note that at the end of 1989 they had outstanding housing loan guarantees of over $620 billion.

Imagine the impact if we could encourage private investors to provide even one-tenth of that amount to small business. That would be all off budget, and would dwarf SBA's outstanding section 7(a) loan guarantees of $14 billion. I really think there is tremendous, tremendous potential for the small business community in this concept.

To start off our consideration this morning, we are going to have a panel of some lenders and securities firms who will describe for us the marketplace that exists and what we might be able to do to reach it, but before we commence, I would like to call upon our new ranking minority member, Mrs. Meyers, for any comments she might wish to make. Mrs. Meyers.

[Chairman LaFalce's statement may be found in the appendix.]

Mrs. MEYERS OF KANSAS. Thank you, Chairman LaFalce. I am glad we are meeting to get some insight into the credit problems facing small business. It goes without saying that the current credit squeeze is stifling small business growth and job creation, and it is imperative that we act to correct this problem.

Today, we will discuss the creation of a Government-sponsored enterprise called Velda Sue. This corporation would establish and guarantee a market for securities based on small business loans. It would initially be funded by $30 million in stock and a $300-million loan from the Federal Treasury. Velda Sue would also have the implied guarantee of a $1.5-billion bailout if it ever gets into trouble.

Mr. Chairman, I support the idea of easing credit for small business because I know that small business is the foundation of our economy and that small business growth means job growth. However, at a time when the Federal deficit is growing unchecked, I cannot see the $300-million creation of a Government-sponsored enterprise that carries the implied risk of a $1.5 billion taxpayer bailout. I think we would be better served to examine what is preventing banks and venture capital funds from lending to small businesses right now. Is the banking industry overregulated? What can we do to encourage investment in small business? Is the dramatic increase in applications to the SBA's Guaranteed Loan Programs a sign that banks have the money to lend but are afraid to without a guarantee?

I think we need to have answers, real answers, to the problems in the lending community. With that in mind, I am glad to welcome our witnesses who represent some of the major forces on Wall Street and the banking community. I look forward to their insights on the small business community's credit problems and their own problems from the lending side. Thank you, Mr. Chairman.

[Ms. Meyers' statement may be found in the appendix.]

Chairman LAFALCE. Thank you. Are there any other members who have any opening statements they wish to make?

Mr. BILBRAY. Mr. Chairman.

Chairman LAFALCE. Mr. Bilbray.

Mr. BILBRAY. I am not going to read my entire statement. I would like to have it put in the record, but I would like to compliment you for introducing this. I think innovative programs are needed now. If we go with the status quo, if we do more investiga-

tions of why the banks aren't extending credit, I think we have heard that until we are blue in the face. We need innovative programs like yours, and to move forward to get the country moving again, and I hope that some of our Republican colleagues on the committee will join in and cosponsor this bill and work with us to get small business going again and getting the economy moving again.

I would like to submit my entire statement for the record.

Chairman LaFalce. Without objection, your entire statement will be submitted.

[Mr. Bilbray's statement may be found in the appendix.]

Chairman LaFalce. Any other? Mr. Sarpalius.

Mr. Sarpalius. I, too, want to commend you on this legislation. There is no question one of the keys to our economy starting up again is in the hands of small businesses. They employ about 80 percent of the work force in the United States. Your legislation does go a long way in trying to help small businesses. We have to remember that Ross Perot started EDS with only $1,000 and that Bill Gates was a teenage college dropout when he started Microsoft, but their questions were how do they get credit to start these enterprises, and your legislation moves in that direction.

Mr. Chairman, I commend you for this legislation. I do have some concerns and questions that I hope in time I will be able to address. Thank you.

Chairman LaFalce. If there are no other comments, we will go to the panel.

Chairman LaFalce. We have Mr. William Gossett, representing the Independent Bankers Association of America; Mr. Frederick O. Terrell, managing director of the First Boston Corporation; Mr. James Murphy, executive vice president of the Fleet Financial Group; and Howard S. Altarescu, vice president of Mortgage Securities Department of Goldman, Sachs & Co.

We will first hear from Mr. Gossett.

TESTIMONY OF WILLIAM GOSSETT, PRESIDENT, LIBERTY NATIONAL BANK, ON BEHALF OF THE INDEPENDENT BANKERS ASSOCIATION OF AMERICA

Mr. Gossett. My name is Bill Gossett. I am president of the Liberty National Bank of Longwood, Florida. I also represent IBAA. I appreciate the opportunity to testify on your proposal to create a secondary market agency, Velda Sue, for small business loans.

As an active small business lender, I support any reasonable proposal to increase lending to small businesses. I am sure this committee has heard many times that we must look to small businesses to create jobs since large businesses of all kinds continue to lay off thousands of workers.

Before commenting on the current business lending climate and the Velda Sue Program, let me tell you something about my bank and our small business lending activities. Liberty National Bank was established just over 10 years ago, and we have approximately $34 million in assets. However, that understates the amount of small business lending that we generate. In addition to the loans

we added to our portfolio last year, we originated $6.5 million in SBA loans sold into the secondary market.

At year end last year, we had another $5 million in loan participations sold to community banks in Illinois, Kentucky, Alabama, and Florida. As you can see, my bank does not share the prevailing regulatory attitude that "loan" is a four-letter word to avoid. Demand for small business loans is strong in our market, but we do face serious problems. I realize this hearing was not called to provide a forum for bankers such as myself to air grievances concerning industry regulators or shortcomings of the SBA. However, it is my belief that Velda Sue loans will not be made in a vacuum, but rather will be subject to the same onerous regulatory compliance and environmental concerns as other loans in our portfolio.

The current regulatory climate discourages small business lending. SBA programs, which otherwise might be a significant alternative, have been significantly underfunded. Congress should address these and other problems at the same time it is working to create Velda Sue. The proposed new agency could provide vital support for a rapidly growing small business sector, but it would be only one element. Banks will continue to make a large share of the small business loans and hold them in their own portfolios. SBA must be strong to support loans which need the shoulder of the 7(a) guarantee to overcome certain risks in an otherwise qualifying bank loan. It is important that Congress take an active part in restoring prudent judgment lending. The regulators cannot do it alone.

The 1989 savings and loan legislation and the 1991 banking law were congressional attempts to micromanage the bank regulatory agencies which, in turn, have attempted to micromanage banking. The pendulum swung too far, and Congress gave it a large push. The agencies will need political support and direction to reverse the trend. Recently, the banking industry united behind a carefully targeted agenda designed to increase small business lending through regulatory burden relief. In a letter to President Clinton, the industry urged him to support legislative and regulatory steps that would stimulate economic growth. A copy of that letter, along with attachments, is included in my written testimony.

I note, Mr. Chairman, that you sent a similar letter to Mr. Clinton and have spoken with the President. We appreciate those efforts and hope that your colleagues will support our efforts to reduce the burden of regulations that is hindering job creation.

Chairman LAFALCE. Since you have referred to the letter that I sent to the President, there are, of course, differences between your letter and my letter. There are similarities, too. But I strongly opposed the 1989 savings and loan bailout, and so far as the 1991 law is concerned, how strongly I was opposed to it until they at least agreed to go along in conference with my amendment, which at least gave some escape clause to the automatic drop-dead date that would have been imposed by the committee. But there is absolutely no question that the pendulum was swung too far in the opposite direction by both the Bush administration and the Congress, and that is a separate, extremely important issue.

It does not at all mitigate the need, in my judgment, though, for an approach such as this. There are many things we need to do to

deal with that problem: Perfect the 7(a) Program even more and further develop the secondary market for Government-guaranteed loans, but also pursue securitization of small business loans absent a Government guarantee.

I just want to clarify that. Please continue.

Mr. GOSSETT. I appreciate that and I agree. By the way, Willie Sutton is a minor problem compared to those laws. Overzealous regulation has led to an increased demand for SBA loans, and the SBA's improved performance has put it in a position to meet that demand. Unfortunately, repeated funding shortages have hindered the SBA Programs.

As an example, at our bank, as we speak, some $2.5 million in SBA loans are bottlenecked, awaiting approval and closure as a direct result of the SBA running out of funds on December 10, 1992. Nationwide, good loans that would lead directly to new jobs are delayed until SBA funding——

Chairman LAFALCE. I don't mean to interrupt, but the window opened up again in January.

Mr. GOSSETT. Yes, sir, I am aware.

Chairman LAFALCE. So, that bottleneck should not have existed on January 1st. There was a bottleneck between December 10th and January 1st. Maybe we can explore that with you at some subsequent time.

Mr. GOSSETT. That is correct. All right. Nationwide, good loans that would lead directly to new jobs are delayed until SBA funding becomes available. This is backward. The SBA should be able to help the economy in troubled times. The economy shouldn't have to wait for arbitrary deadlines to pass. A more reasonable regulatory climate, as well as increased SBA funding, could bring supply and demand back into balance. A well-functioning Velda Sue Program could also play a vital role. However, I would like to add we don't want the program to be structured so that it is unfair competition with banks that want to keep small business loans in their own portfolios.

I understand the Velda Sue could fund loans that are larger than the typical SBA 7(a) loan or a small business loan that a bank may desire to hold in its portfolio. An originator would fund a Velda Sue loan originally and some time later sell it into the secondary market. This is similar to the process lenders use to sell home mortgage loans through Fannie Mae or Freddie Mac, but, from the community bank perspective, there is a critical difference between a home mortgage loan and a Velda Sue loan.

An individual home mortgage loan is much smaller than a community bank's individual loan limit. A bank has no problem holding that loan for a short time, several weeks or a month, before it can be sold. A Velda Sue loan would be quite different simply because it could be larger than our individual bank's loan limit. For example, our bank's current loan limit is $750,000, and, as a matter of prudent banking, we will impose a house limit of $500,000 to limit exposure to a single borrowing entity.

A typical Velda Sue loan for construction of a manufacturing or distribution facility might be as large as, say, $2 million. Under current lending limits, our bank could not participate in the Velda Sue Program for that loan. We could not make and hold the loan

for the construction or interim period until Velda Sue purchases the 80-percent portion of the loan designated to go into the secondary market.

Chairman LaFalce. Of course, you could easily do 10 $200,000 loans, sell them off on the secondary market, and then have that money to make the $2-million loan without recourse to a secondary market if that were your desire.

Mr. Gossett. That is correct, but I can't get from point A to point B in that I can't fund the $2-million loan in that interim period and live with my regulators.

Mr. Bilbray. Question, Mr. Chairman. If you can't make it through this program, could you make it normally?

Mr. Gossett. I can make it through the SBA.

Mr. Bilbray. But this program doesn't preclude you from still going through the SBA and doing it in the normal procedures. You can use either one. You can go either way; is that correct?

Mr. Gossett. I need to correct myself. Say the loan were $1 million. I could go with the SBA. If it were $2 million, I simply could not make the loan.

Mr. Bilbray. But if we pass this legislation, that is not going to change that one way or another, is it?

Mr. Gossett. I will come to it in just a moment. If you will deal with my regulators, it can happen. Finding a solution is important to the success of the program. Since it is geared to small business lending, we would not expect larger banks to be active participants, as is generally the case with the existing SBA secondary market program.

If community banks could not be active, unregulated finance companies would likely be the primary beneficiaries. Once again, an important banking market would be lost to nonbank competitors.

There are two general approaches to solving the legal lending limit and concentration credit problem. One is making adjustments in Velda Sue and the other would be adjusting banking regulations. Velda Sue could be permitted to operate more like the SBA Program, rather than like Fannie or Freddie. Under SBA the guaranteed portion of the loan is excluded for purposes of calculating legal lending limits and so the loan limit issue never arises. Similarly, Velda Sue could issue forward unconditional commitments to fund loans that banks would make. This would only work if bank regulatory agencies agreed that such commitments would be sufficient to override individual lending limits.

Alternately, Congress or the agencies could change lending limits to permit banks to fund Velda Sue loans for a reasonable time so long as a portion of the loan to be retained by the lender does not exceed the bank's legal lending limit. This should be acceptable from a safety and soundness point of view as long as the bank had a clear intention to sell the loan into the secondary market and the loan meets conditions of that market. Whichever solution to this problem that you adopt, it is very important that it be acceptable to the bank regulatory agencies. Unless they agree, community banks will be unable to fully participate in Velda Sue.

In conclusion, the Velda Sue Program could be an important element of an expanding economy, but loan limit rules must be ad-

justed so that community banks will be able to become active participants. In addition, Congress and the bank regulatory agencies should review and adjust their current policies that are discouraging small business lending. Finally, Congress should fully fund SBA Programs. They are working well, but the lenders and borrowers are quite discouraged by the funding delays. I thank you for the opportunity to testify.

[Mr. Gossett's statement, with attachments, may be found in the appendix.]

Chairman LaFalce. Thank you, Mr. Gossett, for your fine testimony. I want you to know that it is certainly my intent and the intent of this legislation that the portion of the loan which would be sold to or guaranteed by Velda Sue should not count against the lender either for loan limit purposes or for purposes of calculating risk-based capital requirements.

Now, we will need to work through the mechanics of the system, but I believe we can deal with that by clarification. No question about it; we want to make sure that the entire Velda Sue concept is an attractive one for businesses and lenders.

Mr. Bilbray. Mr. Chairman, I know we would like to go on to the other witnesses, but I want to clarify one thing for Mr. Gossett. He says if we don't do the things he has asked, they will not be able to participate in the program. I still don't understand that. You can't make the $2-million loan under those premises, but you certainly can make smaller loans, right?

Chairman LaFalce. Let's hold off on the questioning.

Mr. Bilbray. I just want to understand his logic.

Chairman LaFalce. We will come on to that a little bit later. I want to get on to the rest of the panel right now. Mr. Terrell.

TESTIMONY OF FREDERICK O. TERRELL, MANAGING DIRECTOR, THE FIRST BOSTON CORP.

Mr. Terrell. Mr. Chairman and members of the subcommittee, I congratulate you for holding this hearing and examining the creation of Velda Sue for an enhanced business environment for small business lending. On behalf of First Boston, I would like to add that we don't believe any other area of the economy can use help more than the small business community, given its effect and importance in terms of job creation and other effects on the economy.

My name is Frederick O. Terrell. I am a managing director with the First Boston Corp. I have been with the firm since 1983. First Boston, as you may know, is a full-service international investment banking firm serving both suppliers and users of capital around the world. In my current capacity I serve as cohead of the firm's Conventional Issuance and Trading Group, which has the responsibility of delivering mortgage and asset-backed investment banking services to banks, thrifts, and Federal agencies, and to other entities operating within the broad financial institutions arena.

I might also add that First Boston has had the opportunity, the luxury of being involved with a great many Government-related programs in the asset-backed and mortgage-backed area, an opportunity we have taken very seriously. We have enjoyed being a partner of the Federal Government in this enterprise.

With that said, Mr. Chairman and members of the committee, I would like to talk more conversationally about my testimony and talk a little bit about the comments I would like to make today with respect to Velda Sue. They are three principally. The first is the value of liquidity, because I think that is the essence of a secondary market, and the importance of Velda Sue.

The second is will the market accept Velda Sue? I think the answer to that is, yes; but in focusing on that question, I think the role of the investment banks here, with all due deference to my colleagues, I think the lenders to my left and right will make the program work. I think the investment bankers are intermediaries. I believe that the most important thing is to make sure the parties agree and get together and work these things out, because it is very hard to do that in the abstract.

In acknowledging that, I think that the thing we can help most with, if I might say so, is talking about the value of secondary markets and whether the paper will sell. The third comment I would make is what will be the impact, as we see it from our own view, of the importance of small business lending? Again, I think that Mr. Gossett and Mr. Murphy will have comments on that which will be relevant to the committee and to you, Mr. Chairman, which supersede our own comments because they are the people who have to live with this program. But starting off, I guess I would say that the value of liquidity cannot be overestimated or underestimated, I should say.

Secondary markets, in addition to creating an opportunity for investment bankers to lay off risk from securities that they have bought, provides opportunities for lenders to do the same thing. I think in my written testimony I have taken some time to explain the value of liquidity in the marketplace. I think that is the principal advantage of secondary markets. I would also say that there is an ancillary effect and benefit which is that it creates discipline in all areas of the market, not only from the lender's perspective but from the investment banker's perspective and the user's perspective.

There are several examples of very successful secondary markets. We applaud the Velda Sue concept because we think that it replicates what has already been a successful experience at Fannie Mae and Freddie Mac and with Farmer Mac and other GSE's that are doing the same thing that Velda Sue intends to do in the small business sector.

Will the market accept Velda Sue? We believe, yes, for two reasons. First, and principally it will be a GSE credit. That is to say it will not be a direct Government-guaranteed credit. There is great acceptance for both Government-guaranteed credits, as we can already see in the Section 504 Program of the SBA, and the 7(a) Program and the SBIC Program to help venture capitalists as well. We think there is great acceptance for both GSE credits and for Government guarantee credits. Focusing specifically on GSE credits, we think the safety and soundness issue is first and foremost. Investors take great comfort in knowing there is even an implicit Government guarantee supporting an issuance of securities. A direct issuance would take even greater comfort, but we think they take, again, great comfort with the GSE back stop.

We think the examples of Freddie Mac and Fannie Mae are self-evident, and the newer experience of Farmer Mac and even Sally Mae, not in the lending area the same way as Fannie and Freddie, but also provides evidence to that fact.

We think also that the second comfort level, in addition to receiving comfort on the credit issue with respect to securities has to be familiarity with the collateral, and I think that the evidence is in the last several years a great expanded market for asset-backed securities has emerged in the capital markets. There is great familiarity, or I should say greater familiarity, with types of collateral which would have never been thought to have been securitizable, if you will, several years ago.

A broad, asset-backed sector, which includes programs which are SBA-related, as I have mentioned, the 504 Program is a very active and I think successful program, as does the SBIC-guaranteed programs today. I think also the RTC's Program of securitization has been very helpful in developing the securitization concept as it relates to different types of collateral which were not heretofore securitizable, and I think in a way that the Federal Government, and I know this might be a little controversial, has helped to pay for the R&D cost of securitizing collateral which would not have been in securities form years ago.

The RTC today is securitizing everything from commercial loans, performing and nonperforming, which are considered hard to sell assets, which there was no market for before the RTC. As a motivated seller, that is their mission to do so. Without speaking the philosophy of the RTC, which I think gets into other ramifications which I will avoid for the time being, I think the bottom line is——

Chairman LaFalce. There is no relationship between the RTC and Velda Sue.

Mr. Terrell. Absolutely no relationship between Velda Sue and the RTC, but I would say, Mr. Chairman, that the experience gained in the RTC context with respect to unusual types of collateral, and I think in the Velda Sue context this collateral, C and I—commercial and industrial—loans are collateral which we have to be a little bit more careful in terms of securitization markets. There is support for securitization of those types of pools, and that R&D will go a long way in helping Velda Sue.

With respect to small business lending, I think it is an open question, quite frankly. I think that the Velda Sue concept, in terms of expanding the market for small business lending, is an excellent concept, and we are wholeheartedly supportive of it. I would say just a couple things in support of that, and that is I think it will be a much more important vehicle if it is used, and for it to be used it should be sufficiently flexible enough to deal with various constituent groups who have to use it.

As I pointed out, the gentlemen to my left and right are important to have on board with a number of other constituency groups as we get to the fine-tuning of this legislation. Just as an example, I think that flexibility is important to build into a program going forward. If we look at the SBIC Program on behalf of the SBA, even now in the last year, legislation has been passed which provides more flexibility for that program to deal with the specific needs of venture capitalists. Before, funding for that program was

based on fixed-rate borrowing which was not always conducive to the needs of venture capitalists which may not see an equity return, a return on their investment, for several years. A much more forgiving lending structure was needed, and I think that is now in place.

I think this is an example of going forward, having the flexibility to adjust to meet the various needs of constituent groups which will be benefiting from that, both lenders and users.

I would say the third point is that the program must be sensitive to the needs of banks and capital requirements, Mr. Chairman. You pointed out the necessity for that. We would wholeheartedly endorse that. Given the experience of Farmer Mac, we think in their experience it has been important that over time that matter be addressed, and it is more important for it to be addressed in the beginning than in the middle of the program. I am sure that will be done in the context of Velda Sue.

The second major point is I think the program itself will require some ramp-up period for people to become familiar with it, and with that, in connection with that, I think it is important that we all control our expectations because these things take time, and secondary markets are not created overnight, and I don't mean to preach to the converted in many cases, but I think that is something that has to be controlled because it is an important idea which will need to be adjusted over time to make it as useful as possible. I have already dealt with the idea that it should be flexible enough in the future to deal with different issues.

I think another example of that is the Farmer Mac linked portfolio strategy which has been incorporated into the Velda Sue legislation. That is that Velda Sue will be able to purchase securities or MBS's created by lenders. I think that is important for, if you will, priming the pump of the market to start with.

Chairman LaFalce. If we want to do something quickly, it is almost necessary.

Mr. Terrell. I believe that is true, Mr. Chairman. That is also an example of a feature that was built in after the program was already put together. I am encouraged that feature has been incorporated already in the Velda Sue legislation as currently stated.

Chairman LaFalce. We didn't have that in previous versions, in previous Congresses.

Mr. Terrell. I am aware of that.

Chairman LaFalce. Thank you.

Mr. Terrell. Another feature I would point out is that I think that the Velda Sue Program can be used to complement existing Government-guarantee programs in that Velda Sue requirements for $18 million of net worth is a fair and appropriate cut-off point, but that may leave some small businesses without the opportunity to participate in Velda Sue. I think it might be the case that over time some of the better credits might be able to participate in Velda Sue, and I think that is appropriate. However, I think that existing programs like the 504 Programs, the SBIC Program are valuable, and I think one of our comments is that there is an opportunity for peaceful coexistence, cooperation, and a complementary relationship between guaranteed programs and a GSE Pro-

gram that is partially guaranteed, but works primarily with private sector involvement.

Finally, there are a couple of issues that we have not directly addressed or I have not directly addressed, and that is, I think, one of the major issues is, is this the most efficient use of the Government's resources, and I think that will come up over and over again. First Boston has been very involved over time in working with OMB to discuss the value of Government participation and whether it should be directly guaranteed or not directly guaranteed.

I would only say that is an important discussion. I think that there is a role for both guaranteed programs and for nonguaranteed programs, but the benefit of the Velda Sue Program, as we understand it, is that it allows for Government participation of the program. It actually creates a partnership between Government and the private sector.

I think that the structured, the equity structure including warrants, allowing the Government to take advantage of upside potential is innovative. From First Boston's perspective, it is a new role for Government to be a participant with small business in the future.

Chairman LaFalce. We proposed that successfully in the Chrysler Program. We proposed that successfully in the new SBIC Program that we passed in the last Congress. I am also pleased that you have spoken so favorably of the Section 504 Program. That was a program that I authored in 1980 which I think has been one of the stars of the SBA arsenal. A lot of people spoke against it at the time, but it has been great.

Mr. Terrell. Oh, we agree with you.

Chairman LaFalce. Sam Nunn deserves at least equal billing. He was the chief promoter of the 504 on the Senate side.

Mr. Terrell. Finally, I think the specifics on how the debt is structured, we have not commented on specifically. I think it is very easy to work out those details. I would say that the debt structure should be as forgiving as possible to facilitate the main purpose of this, which is to enhance small business usage. I think those are things that should be worked out, working with the investment banking community as intermediaries and people who are sellers into the market, but also with the major constituent groups which will be the beneficiaries of Velda Sue.

Once again, I stress that this idea of a partnership, although it has been used in other contexts, I think is a valuable concept and innovative in this context. With that said, again, we are in support of the concept of Velda Sue. We look forward to working with you, Mr. Chairman and members of the committee and the Congress, in fine-tuning this approach as we think it is beneficial and supports one of the most important ideas in the economy, and that is the promotion of small business opportunities. Thank you very much.

[Mr. Terrell's statement may be found in the appendix.]

Chairman LaFalce. Thank you. Our next witness will be Mr. James P. Murphy, executive vice president of the Fleet Financial Group. Mr. Murphy.

TESTIMONY OF JAMES P. MURPHY, EXECUTIVE VICE PRESIDENT, FLEET FINANCIAL GROUP, INC.

Mr. MURPHY. Thank you, Mr. Chairman. Fleet is headquartered in Rhode Island and is the Nation's 14th largest diversified bank holding company with over $45 billion in assets. We have 900 banking offices in the Northeast and a total of 1,400 offices in 42 States and throughout the country.

We are delighted to be here to talk about Chairman LaFalce's legislation which would create a secondary market for small business loans. Our seven banks in New York, Massachusetts, Maine, New Hampshire, Connecticut, and Rhode Island, and our nonbank subsidiaries are very active in lending to small- and moderate-sized businesses. The consumer and the small business, moderate-sized business lending is bread and butter in many ways for our company.

Our seven banks have over $1.6 billion in small business loans outstanding, and recently our New York bank won an award from the SBA for being the top lender among New York banks for the use of the SBA Program last year with $30 million in SBA loans. Most of our small business loans go to businesses with sales of $5 million or less that usually borrow a half million or less. We do make bigger loans to larger companies. Our current small business portfolio consists of a large number of small loans, average size $55,000 to $60,000 across a wide spectrum of businesses. Most of our portfolio is in the retail, manufacturing, construction, and restaurant services, as well as in insurance, and real estate lending.

We reorganized our bank so that we could have a focus within the company to create uniformity and greater efficiencies last year and this focus now of community lending loans of $500,000 or under is working very well. Most of the loans in this portfolio would be well within the parameters of the Velda Sue Program. So, clearly, we support initiatives to increase bank lending and credit availability and are interested in doing everything possible to stimulate the economy in the Northeast, which has been in a deep recession for the last several years. That is why we are intrigued by your idea, Chairman LaFalce.

This program, especially if targeted to small businesses that are having difficulty getting affordable sources of credit from traditional lending sources, could be particularly helpful in improving the economy by stimulating lending to innovative and growing companies that create jobs. This would not only help banks serve their communities better, but it would make them stronger by enabling them to sell the loans and perhaps reduce their risks. A major problem with current small business lending is that each loan structure is individualized and often dependent upon intangible qualities, such as management skills of the potential borrower, along with pure financial data, such as cash-flows and the like. This means that small business loans are relatively ill-liquid and generally not securitized and sold into a secondary market.

If something were done to increase the liquidity of these loans, it would make more capital available for small business lending. It goes without saying. H.R. 660 attempts to do this by creating a GSE similar to Fannie Mae to encourage the development of a sec-

ondary market. As I understand it, the way this market would work is that a potential small business borrower would come to a bank and apply for a loan. The bank, which would serve as a primary distribution network for this program, would profile the loan against both its own underwriting standards and those of the Velda Sue, those standards which are to be mandated by the Velda Sue board. Qualifying loans would then be sold either individually or as a pool to Velda Sue or a private certified loan pooler to be packaged and sold as securities in the secondary market.

The originator of the loans would retain the servicing. Fleet is active in small business lending, as I mentioned, and is always seeking to provide credit to those who meet our underwriting standards. However, if one takes the view, as the sponsors of this legislation do, that the credit needs of small business are not being adequately met by the current system, the development of a secondary market makes a good deal of sense.

In theory, it would make more capital available for additional lending, especially to those borrowers who need extended term loans at fixed rates, which are often very difficult to obtain in the current market. For example, an existing customer of the bank who is already being extended short-term credit needs to buy real estate or heavy equipment to expand his business. Instead of expensive short-term credit, he wants the bank to give him a long-term, fixed-rate loan. The problem in the current system is that due to the credit risk that would be retained by the bank, since there is no secondary market for this loan, it would be difficult to obtain such a loan from the lender.

This result is in part driven by the experiences in the regulatory side over the last several years with huge loan losses, and in part it is driven by a conservatism which derives from a slow economic velocity in many markets throughout the country. However, with the Velda Sue secondary market in place, the lender could provide the long-term, fixed-rate loan and then sell it to a Velda Sue or a loan pooler. This looks to me to be one of the greater opportunities that Velda Sue might be able to seize.

The SBA's current 7(a) guarantee program, I might also add, is not flexible enough to help banks make small business loans in distressed communities. For example, it is nearly impossible to get an SBA guarantee on a line of credit which is the product most small businesses need the most. Velda Sue, through its guarantees, may provide an alternative to help with this problem. The wild card in this, of course, is the price. The key question for potential borrowers will be whether market conditions will allow the bank to provide an acceptable and competitive interest rate to make these type of loans worthwhile. To be successful, Velda Sue must be structured correctly and overcome a number of problems that have impeded the development of a secondary market for small business loans thus far.

One critical issue that must be dealt with, which has already been identified in the legislation, is the development of uniform underwriting standards, the details of which are left to Velda Sue's permanent board. For instance, right now lenders and investors do not have confidence that they can predict the performance of commercial loans, particularly small business loans. Therefore, it is

hard for them to determine what someone would be willing to pay for these loans. Predictability and thus the ability to judge risk would be enhanced by standardized underwriting. This may be a difficult task.

Commercial loans in general are not standardized because there is usually little basis for comparability between businesses. Variations exist in the appraisal of the value of one business compared to another. Also, comparing cash-flows can be a major problem. All of this means that it is very hard to standardize the necessary documentation and no one has been very successful so far in putting all of this together in the private sector. The text of the legislation lists a number of minimum standards for such loans, including a maximum principal amount and term for the loan.

Although these standards are helpful, they do not address all the issues that need to be thought through. Clearly, how well the board does in establishing the parameters of loans eligible to be pooled and securitized by Velda Sue or the loan poolers is critical. We suggest that these guidelines focus on establishing the following: A predictable way to determine the probability of default; a predictable way to determine the probable loss in the event of default; a way to standardize rates of return for investors; a national rather than a regional market; and a way to standardize ongoing loan monitoring and servicing.

For example, parameters would be necessary to define delinquency and at what stage service or intervention would be required. Of course, bank and other insured depository institution participants in this system must be assured that they will not be criticized by their regulators for applying the underwriting standards approved by Velda Sue or, as Mr. Gossett has pointed out, I think very importantly, the limit issues have to be dealt with because you have thousands of community banks out there the size of Mr. Gossett that should not be effectively cut out of the program, and I think that has to be addressed as well.

There are a number of other issues that the committee should consider as it reviews this legislation. For example, although Velda Sue, itself, and not the Federal Government, is the guarantor of the loans and underlying securities, there is still some risk to the Government. For example, if it becomes necessary, the Secretary of Treasury could be authorized to purchase up to $1.5 billion in Velda Sue paper. While the absence of the Federal guarantee does reduce the Government's and taxpayers' risk, the committee may want to consider whether a GSE-type structure is advisable and even necessary. If so, for how long.

I think, Mr. Chairman, you have already alluded to that. Banks and other insured depository institutions are eligible to buy stock in Velda Sue. We support this idea, but one incentive the committee might want to consider is providing some form of CRA credits for those institutions that do invest in Velda Sue. Some thought should be given to the maximum terms set forth in the legislation, 30 years for land and 10 years for equipment. These terms may be too long for most banks because of the risks involved in holding loans for that length of time.

Another key determination that the committee must make is whether a market exists for these types of loans if and when they

are standardized. Without the benefit of a Government guarantee, investors would need to have a good grasp of the risks involved, and pricing which may be high, must reflect that risk. My assumption is that a market does exist, but this issue is better addressed to a large extent by my colleagues here today from Wall Street, but in any event, as this is a due diligence process by the committee to see whether this kind of a vehicle would work, I think the process of determining those things has to be one that involves lenders, users, and the investment banking community.

In other words, this is a great idea, but let's look at all sides of it and keep the ball moving and see how it can be made to be something that will work. One additional aspect of the Velda Sue proposal which should be kept in mind is its potential usefulness in enabling banks to more readily respond to the credit needs of small businesses in low- and moderate-income communities and its potential positive impact generally for those communities. CRA encourages banks to make sound loans within their communities, and, in many cases, these loans could be eligible for secondary market opportunities contemplated by this legislation.

As Velda Sue gains experience, more difficult credits might be handled through special supplementary programs for small business analogous to those targeted for first-time home buyer and related programs afforded by existing secondary mortgage market agencies such as Fannie Mae and Freddie Mac. In addition, the Clinton administration is expected to make a proposal with respect to community development banks in the very near term.

The House Banking Subcommittee on Consumer Credit had hearings on this last week. I am not going to go into the detail on community development banks except to say that Velda Sue could make programs currently supported by the banking industry, either directly or through their community development corporations, more effective because of the outlet the legislation would create for their current loan portfolios. In fact, Velda Sue could provide benefits to the entire network of Federal, primarily SBA, State and local Government, and community-based community development programs by making them more attractive as capital- and credit-generating vehicles for the low- and moderate-income impacted communities.

If a portion of the proposed $850 million to develop a new national community development trust were made available—this is an informal proposal talked about in the Wall Street Journal last week—but if a portion of that $850 million were made available to jump start secondary market activity under Velda Sue and low- and moderate-income communities in addition to all the other things that this legislation is intended to do, this result could be achieved more quickly than expected and might obviate the need for a major community development bank initiative.

Mr. Chairman, members of the committee, and there are many members of the committee here today which shows the strong interest that I believe underlies this proposal, if Velda Sue is structured properly, it could enable banks to make more long-term, fixed-rate credit available to small businesses across the country, and I appreciate the opportunity to be here. I think you are on to

something, and we want to be part of the process of trying to make it a feasible and doable proposal. Thank you.

[Mr. Murphy's statement, with attachments, may be found in the appendix.]

Chairman LaFalce. Thank you very much, Mr. Murphy. Our final witness today will be Mr. Howard Altarescu of Goldman, Sachs and Co.

TESTIMONY OF HOWARD S. ALTARESCU, VICE PRESIDENT, GOLDMAN, SACHS & CO.

Mr. Altarescu. Thank you and good morning, Mr. Chairman and members of the committee. My name is Howard Altarescu. I am a vice president of Goldman Sachs, and I am cohead of the Structured Finance Group in the Mortgage and Asset-Backed Securities Department at Goldman Sachs. Goldman Sachs is one of the lead investment bankers for the Small Business Administration's SBIC Program, and is a leading investment bank in the areas of mortgage and nonmortgage asset securitization, including extensive work with Fannie Mae and Freddie Mac. We also actively trade senior secured bank loans of the kind under discussion today.

I have been asked to comment on the potential viability of Velda Sue, as well as the relative merits of the small business loan-backed securities to be issued or guaranteed by the new corporation compared to securities of other GSE's. Let me start by stating that there is every indication that there is a need in the small business community for a program like Velda Sue, and that we believe that Velda Sue securities will, in fact, trade like other GSE securities. In addition, I share the Chairman's view stated earlier that the GSE Program may well be the forerunner of a non-GSE fully private sector program to achieve the same purposes as Velda Sue.

Certainly the Freddie Mac and Fannie Mae examples may be apropos here. Issues regarding viability; which is to say can the private sector, in fact, or will the private sector, in fact, be a partner of the Federal Government, and will a public offering of Velda Sue securities, meaning the equity in the first instance, be successful? Certainly this needs support of the lenders. The lenders alone can determine, with input from borrowers, whether there will be demand for loans of the type that will be covered by Velda Sue.

Testimony of the lenders such as we have had, and from others, may provide the basis for a business plan which would indicate a projected volume of business and related revenue which would be useful for supporting an initial public offering. Ordinarily, IPO's are based on actual historical experience and projections based on that experience. In this case, strong, forward commitments or other arrangements to assure a revenue stream would provide a degree of comfort to equity investors. However, it is very important that there be evidence of sustainability of the business and strong management because those are often, and should be, prerequisites to a successful public offering.

As I have mentioned, the lenders themselves who will be secondary beneficiaries with the small business borrowers being the primary beneficiaries, the lenders must be supportive of the program, and just as Freddie Mac, which was originally restricted to doing

business with thrifts, was originally launched with the Federal Home Loan Bank Board or thrift capital, user capital, which is lender capital, especially at the outset, may be the most readily available source of capital for Velda Sue, as well as the best indication of how much the industry wants this kind of a program.

The value of that equity will be heavily dependent on the credit risk of the assets to be owned or guaranteed by Velda Sue. A number of the individuals who have just testified have indicated that banks frequently do not lend or do not lend long term because of credit concerns, and that Velda Sue will provide a needed outlet for those loans where there isn't a desire to hold the credit risk. However, these loans, many of which are smaller, certainly, than the ones we normally trade, are in a category which are most risky from a traditional credit perspective both because of the small size of the borrower and the intention that they be long term.

Equity investors will have as much interest and even more than the bank lenders in understanding that credit risk. We look to the lenders in the first instance to help develop the story for the equity investors and perhaps to be the equity investors themselves.

There are a number of technical issues described in detail in my testimony, which I will simply refer to, which will be important in determining how much credit risk there is in the corporation. One is the retention of risk by the lender itself. The legislation, as proposed, speaks in terms of 20 percent of the risk being retained by the lender, and 80 percent going to or being guaranteed by Velda Sue. There does not appear to be a requirement that the 20 percent be retained. We would propose that retention of that 20 percent be either required or that the servicing, which is a critical component to the credit risk, be transferred with the 20 percent retention if that amount gets transferred.

In addition, and this is another bank regulatory issue which the Chairman has indicated needs to be clarified, clarification should be sought from the bank regulators to determine whether, if the banks retained a subordinated interest, they would be required to keep the entire loan on the balance sheet. Bank retention or any originator's retention of a first-loss position in a loan gives the senior holder, meaning the equity investor, or the Federal Government here, a much greater likelihood that its interests will be served.

Another point that needs substantial clarification is the actual loss experience on small business loans. Available statistics are likely misleading insofar as they refer to chargeoffs. It is our understanding that large percentages of nonaccrual loans are not charged off but rather are restructured, and I have no question about whether that is an appropriate business practice. It certainly appears to be. However, from the point of view of Velda Sue, which will be guaranteeing to investors timely payments of principal and interest on securities sold, whether that loan is charged off or restructured, there is credit risk to Velda Sue, and I think there needs to be substantial discussion about actual charge-off rates and incidence of restructuring so that the Velda Sue credit risk can be understood by equity investors.

Insofar as capital requirements, I would simply refer the committee to the legislation recently passed relating to Fannie Mae and

Freddie Mac, the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, which imposed both debt to equity ratios and risk-based capital standards on those two Federal agencies which, as you know, primarily invest in and guarantee single family residential mortgages. It may be appropriate for the standards developed in that legislation to be viewed as a point of departure and for modifications to be made based on the perceived relative credit risk of single family residential mortgage loans and small business loans.

Insofar as the term of the small business loans included in the legislation, as I have indicated, the longer terms that are referred to, 30 years in the case of real estate and up to 10 years in the case of equipment are, in our experience, longer than the term of loans currently made by banks to small businesses. While there certainly is a need for long-term, fixed-rate lending to or borrowing by small businesses, that is an additional evidence of credit risk to be kept by the corporation which will have to be analyzed for equity investors. While there is a great need for standardization, and that certainly was one of the many factors that resulted in the great success of Freddie Mac and Fannie Mae, standardization in small business lending is a great challenge, a challenge that should be undertaken and a challenge that I believe can be met. However, the most conservative lending, as we understand it, is based on understanding of management, understanding of the importance to the borrower of the loan being made, and understanding of the way in which cash-flow from operations will be the source of repayment of a loan.

Appraisals frequently are suspect in that they do not represent resale value, certainly with the passage of time, and particularly with respect to equipment built or purchased for specific purposes for small businesses. It is obvious that in order for equity investors to meet return limits, there must be compelling evidence that the corporation's revenues are more than sufficient to cover its obligations, including all the credit risks I have referred to.

One final point on this particular matter. Many of the criteria for loans which will be acceptable for Velda Sue are left for determination by the board once it is elected, and, as currently proposed, the board would be elected after $30 million of common stock has been sold. We would propose that consideration be given to allocation of seed money for the purpose of establishing these criteria prior to going out with a public offering. This would provide a basis for equity investors to make a judgment about the potential success of the corporation.

On a second point, which is small business loan-backed securities guaranteed or issued by the corporation. The corporation would be chartered by the Federal Government as a Government-sponsored entity and would have a $1.5 billion line to the Treasury. Based on that alone, we believe that the new securities would be traded in the Federal agency security market. The benchmarks would be the other GSE's I have referred to, and the securities here would be traded, based on those benchmarks.

There are a number of technical issues here as well, and they are worth simply referring to, prepayment risk, probably being one of the most expensive factors to be considered. Mortgage prepayment

risk is fairly well understood, but the cost of mortgage prepayment risk results in a cost to the Federal agencies, Freddie Mac and Fannie Mae, and ultimately to borrowers that equals anywhere from 60 to, from time to time, 100 basis points over where Freddie Mac and Fannie Mae or Fannie Mae straight debt would trade.

A simple example would be 7-year straight noncallable Fannie Mae debt which might trade at 20 basis points over the 7-year Treasury, whereas a Fannie Mae mortgage-backed security with a 7-year average life would trade anywhere from 80 to 85 basis points over the 7-year Treasury. So, in this case 60 to 65 basis points is paid to investors for prepayment risk. There is far less understanding in the capital markets as to the prepayment propensity of small business loans.

It is our understanding that in many cases small business loan prepayments result from noninterest-related causes, whether it is transfer of servicing or restructurings or replacement of debt with equity and the like. Lenders may provide additional insights in this area, which is of critical importance in pricing efficiently, which is to say cheaply, small business loan-backed securities to be issued by Velda Sue.

I describe in my written testimony the SBA's SBIC Program simply to point out similarly the large cost entailed in investors taking on prepayment risk. Very simply, SBA and Ginnie Mae are both full faith and credit institutions. However, whereas Ginnie Mae securities, which are subject to mortgage prepayment risk, might be priced at a spread of approximately 75 basis points over the 10-year Treasury, the SBA's SBIC securities might be priced at a spread of 80 basis points or more over the 10-year Treasury. This is a result of the prepayment risk inherent in the SBA SBIC Program, as well as very importantly the relative lack of liquidity in the SBA Program.

Liquidity is of critical importance, and liquidity means both size in aggregate issues as well as size in individual issues. Generally speaking, we would refer to a liquidity minimum of $5 billion in order to establish generic pricing. Each of Fannie Mae and Freddie Mac have over $400 billion of securities in the market and $5 billion is obviously a small fraction of that. In the abstract, that would be our advice or an observation we would make. However, I would also note that the Farmer Mac Program, which has gotten off to a slow start, issued its first public offering of agricultural-backed securities not too long ago. It was only an $88 million issuance, but, in fact, their pricing was attractive to them and within the benchmark range that one would expect for those securities. So, even though in the abstract we would recommend that there be a large program in order to get efficient, cheap pricing, there are exceptions to that.

Insofar as structures of securities, I think it is premature to discuss those in any detail. There are advantages and disadvantages to a number of structural alternatives, including costs and risks both for equity investors who are left with the risk and ultimately for the Government, and those structures and those costs must be evaluated within the framework of the actual characteristics of the pool of loans to be securitized.

Let me conclude by saying that substantial additional input is needed from the lending community, as others have discussed as well, to assure that there is borrower demand for the particular type of loans to be included; and that there is lender demand for the outlet to be offered by Velda Sue; and lenders will give the best evidence of the need for the program by participating in the equity that Velda Sue would issue.

On the second question, the relative merits of small business loan-backed securities guaranteed by Velda Sue, we do believe those securities will be traded in the agency securities market. There are a number of steps to be taken to assure that the most efficient, that is, the cheapest funding, is available for that program.

Mr. Chairman and members of the committee, I hope these comments have been helpful. I am available to discuss further any of these issues. Thank you.

[Mr. Altarescu's statement, with attachment, may be found in the appendix.]

Chairman LaFalce. Thank you very much Mr. Altarescu and all the members of the panel. I think your testimony has been excellent. It provides a good launching pad for consideration of this concept as we proceed to work with the rest of the Members of Congress and especially the Clinton administration. I think you have all pointed out a number of things.

Number one, there is a need on the part of the small business community. There is a need and a willingness on the part of the existing lending community to participate in a program such as this if properly structured. There is an investing community willing to invest in the secondary market. There are difficulties, of course, in properly constructing the legislation, that we should consider in advance, drawing upon the lessons of history, good and bad, Fannie Mae, Freddie Mac, Farmer Mac, and to make sure that we do not repeat any of the mistakes that they may have made.

We have attempted to deal with some of those mistakes. We have looked to the Farmer Mac problem, attempting to have provisions within our bill which don't deal with that. There are problems in bringing about the necessary standardization, to be sure, but I am pleased that all of you think that difficult as those problems are for the diverse nature of small business loans, they are solvable, and we will get on with the task.

I have a whole host of questions, but I will defer my questions so that the other members can have their opportunity, but before we do that, I just want to give you an opportunity to have, if not second thoughts, additional comments that you may wish to make. I often make comments and then say, oh, I wish I had said this or I will hear somebody else and say, oh, I wish I could respond to that. Do any of you wish to make comments at this point that you didn't make before or in response or in addition to comments that others have made? Mr. Terrell. Mr. Gossett, yes.

Mr. Gossett. Yes; with regard to how this program would play as compared to the SBA and coming back to questions from Mr. Bilbray earlier, I would like to clarify that. I think there are something around 10,000 community banks in the country, and the average asset size, according to my information, is something like $42

million, so they must be comparable to my bank. If anyone in the committee is not aware, SBA stops at $750,000 as to the amount of guarantee on the 7(a) Program.

Chairman LaFalce. Except for certain type of loans such as international.

Mr. Gossett. Correct, but by and large that is the limit. Therefore, in a bank my size, about a million two is the maximum you can do on an SBA loan.

Chairman LaFalce. Of course, if you use other programs such as 504, it is different.

Mr. Gossett. We use that, but still I am held to my legal lending limit as to the portion of that I can hold. I think this is important to you as to how it would interrelate, from your opening statement, as an attempt to get some of SBA off budget. I think this program would complement the SBA program, particularly with regard to those larger loans that we are now putting under the SBA, and your question on the $2 million loan, I misled you. I could not make that loan under SBA due to legal limit requirements, but I see for my bank and banks similar to mine, particularly as you get closer to that large SBA loan and as you go up into the $3-, $4-, or $5-million range, that would allow us to offer a product to our communities that we cannot offer now.

Again, it has to be structured so there is no potential liability to us. There is no recourse to us for purposes of risk-based capital and legal lending limits. Thank you.

Chairman LaFalce. Any additional comments? Mr. Terrell.

Mr. Terrell. Mr. Chairman, I would like to respond to two things that my colleague from Goldman, Sachs mentioned, Mr. Altarescu. I would say I agree that I think that liquidity in terms of size of issuance is important, and I think that is a goal we should look forward to getting to. I would say as a surrogate for liquidity in the beginning of the program from the outset, something we have been able to convince investors of in connection with the 504 Program where we serve as a lead manager and also the SBIC Program where we also are a lead manager along with Goldman, Sachs, is that regularity can serve as a surrogate from the outset for size if the investor community knows that an issue is going to come regularly. I think that is very helpful.

If it is a program as opposed to one office, as we call them in the industry, transaction, I think that can convince investors there is a greater commitment to it, and they were willing to invest the time and research necessary to build a program. I think there is nothing like liquidity and size, but, as a surrogate from the outset, regularity in a program, I think, is important.

The second point with respect to prepayment and stability, I go to some effort in my written testimony to talk about preprepayments and their effect on the issuance of securities and the implications for investors. I would say that the committee should take heart in that as prickly as prepayments are with respect to the final investment by the investor and the implications, I think there are structural things that can be built into securities that can mitigate the disadvantages of prepayments inside of a mortgage-backed security. Certainly, the experience of Fannie Mae and Freddie Mac with respect to prepayments and the innovations that have been

created in connection with other programs like the VA, another program we serve as lead manager for where there was no prepayment experience at all or default experience, whether that program started back in 1988 where there is a body of experience now built, I think things can be done.

Chairman LaFalce. It is important to remember that this is a program not designed primarily for either the lending community or the investor community, but for the small business community. We want to make it user friendly, and that is what we have attempted to do in the bill.

Mr. Terrell. I think you are right, Mr. Chairman. My point is that ultimately the lowest rate in securities will benefit the small business community the most, and I think if prepayments are dealt with in the structure, there are ways to do that in our community. I think the benefit can be brought about.

Chairman LaFalce. We are flexible on that issue. There are an awful lot of different ways, some sliding scale on prepayment penalties based upon the time of prepayment, for example. That is a very negotiable—we want something that is user friendly and acceptable, of course, to the investment communities. That will make the program work.

Any additional comments that any of you have? Jim. All right, now we will go to questions. Mr. Bilbray.

Mr. Bilbray. I just had a question I didn't quite understand. Maybe the representative from Goldman, Sachs can explain. When you were referring to 65 basis points or something, I am not a banker so I didn't quite understand what that meant.

Mr. Altarescu. Very simply, if a Treasury security—I don't have a yield chart in front of me, but if a 7-year Treasury security is selling, say, at 6-percent yield today, and Fannie Mae was going to raise 7-year debt, straight debt, not prepayable at all, they might have to pay in the market 6.20 percent yield, so that would be the cost to them.

On the other hand, if Fannie Mae sold a mortgage security which was subject to prepayment risk, the mortgage security yield would have to be substantially higher because investors who bought that mortgage security would be subject to substantially greater risk, and so I was comparing those as a benchmark, and while I agree with Mr. Terrell's statements and the chairman's, the prepayment risk in a small business loan is far less well understood than the prepayment risk in mortgages.

Freddie Mac and Fannie Mae, in particular, have built up a huge body, as well as the industry generally, of history as to how mortgage prepayments behave in various interest rate scenarios, and all of Wall Street has models which, correctly or incorrectly, will project how prepayments will behave going forward, and so when we invest in mortgage securities and sell mortgage securities, we make judgments based on projected interest rates and prepayments, which is how we get to these yield spreads.

As it comes to small business loans, today, there is not as much certainty, and so, for example, if a small business loan could be made and if it was user friendly, where the borrower could not prepay or if the borrower prepaid only with a penalty, which would be a way to compensate the investor, then that would trade better

in the market. There needs to be the give and take between the market and the borrower.

Mr. BILBRAY. Thank you. Now that I know what it is all about, thank you.

Chairman LAFALCE. Mr. Collins.

Mr. COLLINS. Thank you, Mr. Chairman. Mr. Gossett, I regret I missed your testimony. I attended the National Prayer Breakfast this morning and there were several people there who had a lot of prayers, and we all have a lot to pray about. It kind of reminded me of being at home in Georgia on the day that I would visit my bank. I usually had to say a word of prayer before I went to the bank, and when I got there I would have to get on my knees. But now after having been elected to represent the people of the 3d District of Georgia in the House of Representatives, when I walk into a community bank it is just the reverse. Now the banker gets on his knees. His prayer is that we do something about regulations up here, regulations that are strangling banks, that are stifling small business loans, that are hindering the investment in this Nation in communities.

My question to you is, when a customer comes into your bank, a small business applicant, normally you know that small businessman from personal history or banking history. Based on today's regulations, do you look at that person based on the risks involved in the loan or is your attention focused more on the regulations involved in that loan?

Chairman LAFALCE. Mr. Gossett, that is known as a softball right down the middle.

Mr. GOSSETT. Shall I get on my knees to respond?

Mr. COLLINS. Whatever would be your pleasure.

Mr. GOSSETT. I have a friend, and I have a lot of banker friends turned consultants as a result of problems in the industry recently, and he related a story to me. He is now packaging loans and assisting borrowers in getting financing. He told me about sitting through a loan committee meeting on one of those loans recently. He was scratching his head. He had been out of banking for 2 or 3 years. He said, Bill, the first one wanted to know what the regulators were going to say about it. The second one wanted to know what the loan review committee would say about it. The third one wanted to know who did the appraisal and who has reviewed the appraisal, and the fourth director wanted to know about the environmental study, and they turned the loan down without ever even talking about the ability of the borrower to repay or the quality of the credit. So, to answer your question, we first, I think, screen our loans against regulatory concerns and then look at the credit.

Chairman LAFALCE. Mr. Collins, that is what is known as a home run.

Mr. COLLINS. Well, I appreciate that answer, and I knew the answer before I even asked the question. That is another good sign of being smart in your business. I am no "expert," of course, but having been a small businessman in a small community for a number of years, since the age of 17, I have had some banking experience. I have had banking experience with large banks and community banks, and I tend to have noticed over the years that I was more favorably received in the community bank than in the larger

banks. I have also noticed that community banks invest more in the communities where they are located than larger banks.

Larger banks tend to drain a lot of deposits for other loans. So, I have a lot of respect for your bank and your banking system.

Mr. Murphy, you stated in your comments you have 1,300 offices, 42 States, and 7 banks, but you go under the title of Fleet Financial Group. Did you begin your banking career or banking business in Fleet?

Mr. MURPHY. No; I didn't.

Mr. COLLINS. Does this just happen to be a name?

Mr. MURPHY. Actually, picking up on your comment about community banks, the Fleet organization grew out of a combination of Fleet in the New England area as a banking group and the Norstar Banks in New York, and, basically, both of those systems developed as a necklace of community banks coming together to create a larger institution, and so, with that history in mind, our culture is very much one that is local- and community-driven with a great deal of local authority in the banking system.

My own career, I started as a lawyer in New York and then worked for Chemical Bank for a number of years, and just recently within the last 4 years became part of the Fleet Financial Group, So, picking up on your comment about the community orientation, we feel that the more we act like a necklace of community banks with 850 offices in New England, keeping the borrower, the local borrower in mind, the more successful we are, and that is why we have a huge portfolio of small business loans, and that is why we support the concept of this legislation, because we would like to be able to do more of that lending and a viable secondary market would enable us to do more of that, we believe. That is why we are here today.

Mr. COLLINS. What percentage of your portfolio is small business?

Mr. MURPHY. Well, on the banking side of the business, we are about a $32-billion entity. That is total assets. That would be about $24 billion in mortgages, consumer loans, and larger commercial loans, so that the $1.6 billion which is that $500,000 loans or less would, as a percentage of $24 billion, $1.6, I guess, would be about 5 percent.

Mr. COLLINS. OK. Those seven banks in that network of banks you talked about, you bought up which were formerly community banks?

Mr. MURPHY. That is right.

Mr. COLLINS. Are any of them still partially owned by the community?

Mr. MURPHY. Well, our stockholder base is very able in New York and New England, and we have a network of local boards and advisory boards, and, to a large extent, in addition to community and not-for-profit participation on those boards, there is a stockholder ownership reflected, so we try to keep our roots deep into New England and New York. That is critical to our success as a banking franchise.

Mr. COLLINS. In reference to the same question I asked Mr. Gossett about risk versus regulation, would you answer that one?

Mr. MURPHY. Well, I think there is no question but that there has been a near systemic change in the way credit decisions are made from 1989 up to this moment, in part driven by FIRREA, in part driven by regulators being deeply concerned as to why major problems and failures manifested themselves, and last but not least the FDICIA legislation that was passed last year has created a climate and a system where there is very little wiggle room on the part of either regulators or bankers in so many aspects of the credit decision.

I think many customers, people who would come in, people who you would have known over a long period of time who have done business with you, they present a credit situation to you, and, for the reasons so dramatically and effectively indicated by Mr. Gossett, the credit is not processed. The bottom line is many things that were bankable 4 years ago are not bankable today, not because the banker doesn't want to do it, but because the regulations have a chilling effect on that kind of a decision.

I don't want to make this an excuse for inaction. We are still very active. Saying that we have a $1.6 billion small business loan portfolio, that is not a static situation. As we speak, perhaps $20 or $30 million of those loans will be paid off today, and what we want to do is to be able to replace those loans that are paid off with new loans, and that is why we are here to work with you all on the possible development of the secondary market. That is why, in other committees of the Congress, either ourselves or our trade groups are articulating concern about the regulatory negative impact and so forth, so many folks that we know, we are just not able to accommodate them today. Yet from a point of view the "C" known as character in the credit decision is not questioned. It is the construct that we have to work within driven by regulatory dictate.

Chairman LAFALCE. Mr. Collins, your time has expired. We will come back to you in a second round.

Mr. COLLINS. I appreciate that. Thank you.

Chairman LAFALCE. Mr. Sarpalius.

Mr. SARPALIUS. Thank you, Mr. Chairman. Mr. Gossett, I would just like to reiterate a little bit more on what the gentleman was talking about on regulation. In your testimony you talk about a letter you sent to President Clinton outlining some of the regulatory burdens that you face as a community banker. Is there any way I can get a copy of that letter?

Chairman LAFALCE. It is attached.

Mr. GOSSETT. It should be attached to the back of the testimony, sir.

Chairman LAFALCE. But much more important than that is the letter I sent, which is not attached. We will make sure you get a copy of that, Bill.

Mr. SARPALIUS. Then another thing I wanted to ask is do you think with this program it is going to create additional regulations on you or on community banks across this country?

Mr. GOSSETT. I personally see no reason why it should. I just want to be able to utilize this program under the structure of existing regulations without having unnecessary problems with it.

Mr. SARPALIUS. Another committee I serve on is the Agriculture Committee, and one of the concerns we have there is that although

the FmHA loans that are given to farmers are basically supposed to be temporary loans for producing crops, but since there is so much bureaucracy that banks have to go through as far as guaranteeing any of those loans, banks won't do it. Very few banks will guarantee those loans, and the reason is the Federal Government—their fear is of the security of those loans.

If a farmer goes under, they are not convinced that the Federal Government is going to come back and repay those loans for them. Under this program, if a small business goes under, what security does the community bank have that that loan is going to be paid off?

Mr. GOSSETT. I can only relate to my experience with the SBA there, which it has not been a problem with us. I am assuming we are relying on the full faith of the U.S. Government to take us out of it as the agency says it will do. I do not perceive that to be a problem.

Mr. SARPALIUS. OK. Let me ask Mr. Murphy, you indicated you had a certain percentage of your loans going to small businesses. Any of you who would like to respond to this, I would like to get your opinion. If we come in, and we provide a program where the Federal Government will guarantee or will buy some of these loans, what assurance do we have that as that frees up your ability to make more loans to small businesses, you will make those loans to small businesses?

Mr. MURPHY. Well, I think our track record with SBA is a very strong one, and it is a growing one. I think that is an indication that we are using a program that is in existence. As I indicated earlier in response to Congressman Collins, we are basically a necklace of community banks across the Northeast, and a major part of our business is the small business customer, but we have to make sure we are not overdoing it in one area of risk as opposed to another.

With a secondary market vehicle available to us, we would be able to have a greater velocity and volume of activity with small businesses because that is good business. It is a market that we like because the pricing is good. It is labor intensive to a large extent, and we see opportunities for more activity in the area with a secondary market outlet for ourselves, and I think that is about as firm a commitment as I could give this committee that would utilize the program, but it certainly would be a very attractive program for us for the reasons that I said.

I think one of the points I made at the end of the testimony is, and I would urge the committee to think about this, we have a tremendous problem not just in the small business area generally but small businesses and not-for-profits in impacted communities across America have an even more serious problem, and it may well be that Velda Sue could be in part an answer to that problem. I don't say that Velda Sue should be constructed simply to respond to the community development needs of impacted communities, but there may be an aspect of what Velda Sue would do that would be very helpful in that area, and it might help Velda Sue as a political item within this Congress to get it moving, and it might help in terms of the administration taking an interest in it, and I say that out of experience because I am the corporate CRA officer for Fleet,

and we work everywhere from Buffalo out to Hempstead, Long Island, and we are working in Hartford, Providence, and Boston, and many impacted communities, New Haven, Bridgeport, et cetera, et cetera, and we have to make sure that something happens that is positive in New York City for those communities, as well as the overall market. So, I would urge that the committee think whether there isn't some aspect of the utility of Velda Sue that would deal with some of those problems, and in many areas also in our market we deal with rural America where we are a very major provider of credit to the agricultural industry in New York.

New York is the fourth largest agricultural State in the Nation, commodity, primarily cash crops, dairy, et cetera, and many of the rural areas of New York are hurting as well, so they are part of our CRA outreach, and so there may be some aspect of this program that would benefit urban and rural America as well as the more general notion of providing a good vehicle for small businesses generally.

Chairman LaFalce. Thank you. Mr. Dickey.

Mr. Dickey. Tell me, if you all will quickly because I am going to have to leave, why do you think that we have not had a program like this in America in the financial community before now? Especially after I have been introducing the bill for 10 years.

Mr. Altarescu. I hesitate to answer in that context. We have all mentioned the difficulties of securitizing small business loans. I think that has been a major issue. There are a number of technical issues, some of which have been resolved very recently in the securitization markets, and I think it is a very difficult process. There are a number of challenges we have all identified. Perhaps the time has come, but there have been a number of attempts to securitize small business loans as you look back over the last 3, 4, or 5 years, certainly in the private markets.

There are now transactions beginning to come forward in the private markets. The homogeneity of small single family residential loans are the primary asset securitized in the market. This may well be one of the more difficult, and so it has just been a matter, I believe, of evolution, and now there appears to be a far more pressing need, and this kind of legislation I think will resolve many of the issues.

Chairman LaFalce. If I may augment that answer, I would certainly agree with that. I think you have to distinguish between the political reasons that it hasn't come to be and the practical reasons. I think the political reasons that, say, a Government-sponsored enterprise has not passed is that it would require affirmative executive branch promotion. Neither the Reagan nor the Bush administration opposed this concept. Indeed, they understood that it had some attractive merit to it, but they refrained from sponsoring it themselves.

You need executive branch leadership in order to create a Government-sponsored enterprise. Now, why would you need a Government-sponsored enterprise? Because the private sector finds it too difficult on their own to bring about the type of standardization that is necessary with such diverse loans as exist within the small business community as opposed to the type of loans that exist in

the residential market. Although I would have hoped it would have happened through the private sector alone, it didn't because of the difficulties.

It is my judgment that you need a GSE to jump start it, to make the market, but once you make the market, very possibly you can self-destruct, and I would not be opposed to that. Once the market is established, then perhaps you could let the private sector carry it on their own, but I think you need the jump start. I apologize for interrupting, but I wanted to augment. Mr. Dickey.

Mr. MURPHY. Mr. Chairman, I think there are a lot of factors. I think it is the moment. We have had a deep recession. Major companies are still laying off thousands of people. Historically, the small business community has been the generator of jobs and wealth; that is, capital and wealth for the society, and I think there is now a convergence of circumstances that is making this something that ought to be looked at more seriously.

Chairman LAFALCE. I think the unfortunate consequences of FIRREA and FDICIA increased the need.

Mr. GOSSETT. Although not apples to apples, I think you do have a test case, and I think you already do to some extent have such a program in place through the SBA secondary market, and it is successful, and it is working, and many of the concerns that we are expressing here have been dealt with. It just has budgetary constraints and also, due to size limitations and what have you, has inherent constraints on it. With regard to the question earlier——

Chairman LAFALCE. But that is so different because there you don't have standardization. You have individual ad hoc judgments by the Government agency, and you must have some way of augmenting that, some way of facilitating that process. Again, not as a substitute, but a supplement. That is the basic difference between that program.

Mr. GOSSETT. I understand, but there is a demand for it, and there is an acceptance for it in the marketplace among investors is my point. The other question earlier about would banks participate, the small business lending we do generates jobs, and grows our community, and does all those "attaboys" that we like, but we are also profit motivated, and if this program is offering a product that is user friendly to the lender, that we can go out and make it user friendly to our borrowers, we are going to be in there because of profit.

Mr. DICKEY. Let me tell you what my concern is, that we are going to create a vehicle that will cause greater losses and you all will be sitting there saying "Well, we are not going to investigate this closely, and the Government is picking up this, and so forth," and the borrower comes in and says, "Well, I might as well take a chance here; we have a chance where I can do it a lot easier."

What I want to know, and I am for this, I really am, and my question is trying to support it or trying to get the factual basis to support it, but what I want to know is do any of you all think that if this program goes into effect that we will have greater losses in the small business financial world than we have now?

Mr. TERRELL. Congressman, if I may, it seems to me, I think it is actually intuitive the other way. I think losses may be reduced because in this legislation you are forcing the private sector to have a

vested interest in those losses by having the first loss component being on their balance sheet.

Mr. DICKEY. Explain it.

Mr. TERRELL. In the legislation, as currently contemplated, the first loss or the first dollar loss has to hit the subordinate piece that is retained by the institution that is making the loan. What that will do is force the lending institution, I believe, to make loans carefully, knowing that their dollar is the dollar that is risked first.

Mr. DICKEY. Then the other side of that would come about that we might have more restrictive loan policy?

Mr. TERRELL. I would defer to my colleagues, but it would seem that underwriting standards——

Chairman LAFALCE. Let me correct you on that. I think that was one of the mistakes of Farmer Mac. What we have done is to go to pro rata loss sharing, OK? But so that the originating lender would at all times be subject to loss, but so, too, would the GSE. There are different ways of handling that. We handled that by requiring that he have a 20-percent interest. Now that, of course, you could have some problems with, too. These are the details that need to be worked out.

Mr. MURPHY. Congressman Dickey, 20 years ago we did not have an efficient first mortgage market for home ownership, and 40 years ago we didn't even have a market. It was a year-by-year balloon that people had when they borrowed, and if we can see that as a continuum that perhaps leads us to find better ways to finance the small business community, then I think what we will have is not only an efficient market, but a market that will have tolerable loss, loan loss ratios. I think that is what we are trying to do here.

Mr. DICKEY. Let me ask you this as I am walking out, if you all were voting on this bill, would you vote in favor of it?

Mr. MURPHY. Yes.

Chairman LAFALCE. Let's go down the line. Mr. Gossett.

Mr. GOSSETT. Yes.

Chairman LAFALCE. Mr. Terrell.

Mr. TERRELL. Yes.

Chairman LAFALCE. Mr. Murphy.

Mr. MURPHY. I said, yes.

Chairman LAFALCE. Mr. Altarescu.

Mr. ALTARESCU. Yes.

Chairman LAFALCE. Smart panel; hand picked.

We have a quorum call, and all the questions I have are extremely technical, and I think we can deal with them in a private setting rather than in a public setting.

Mr. Flake, Mr. Hilliard, do you have any comments that you wish to make?

Mr. HILLIARD. I have none, Mr. Chairman.

Mr. FLAKE. Just one comment, Mr. Chairman. First of all, I would like to welcome the panel and Jim Murphy, who I have worked with in his former role as president of the New York Bankers Association. One of the things I would encourage all of you to do, even as we look at ways to remove some of the more onerous and burdensome regulations, to look at our Bank Enterprise Act which passed the Congress last year.

I think the Bank Enterprise Act can help in this endeavor. Velda Sue and bank enterprises are not mutually exclusive, but I think supportive, and I would like for you to take a look at this relationship as the President continues discussion about community development banks. I think these two pieces of legislation will be extremely helpful in getting this economy rolling. In the interest of time, I will ask no further questions, Mr. Chairman.

Chairman LaFalce. Mr. Hilliard, any comments or questions you wish to make?

Mr. Hilliard. I have none, Mr. Chairman.

Chairman LaFalce. You sure? OK. Because of the quorum call, I am going to adjourn today's hearing, but again I want to thank the panelists, and I would love to have further dialog with you and other experts of diverse perspectives so that we can further establish both the need and perfect the legislation. Thank you very much.

[Whereupon, at 11:23 a.m., the subcommittee was adjourned, subject to the call of the Chair.]

CREDIT AVAILABILITY FOR SMALL BUSINESSES

THURSDAY, MAY 6, 1993

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The committee met, pursuant to notice, at 8:45 a.m., in room 2359-A, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the committee) presiding.

Chairman LAFALCE. The Small Business Committee will come to order.

Today, our committee continues its series of hearings into the availability of credit for small business.

As most of those present know, I have long advocated the establishment of a new entity which I call Velda Sue. This new entity would essentially securitize small business loans and match small business borrowers with investors with long-term funds such as insurance companies and pension funds.

Certainly, this is not a new concept. I introduced my first bill on this in 1984. We have promoted loans to the housing industry in this manner for 50 years through the Federal National Mortgage Association, or Fannie Mae, and through the Federal Home Loan Mortgage Corporation, or Freddie Mac. More recently we established a similar entity to make loans to agricultural businesses through the Federal Agricultural Mortgage Corporation, or Farmer Mac.

Let me put housing and small business loans into some perspective. As of March 31, 1993, the total outstanding portfolio of SBA business loans was less than $16.3 billion; on the other hand, Fannie Mae alone provided over $600 billion for single family mortgage financing in just the past 5 years. I don't want to decrease what is happening in housing, but I would like to increase what is happening in the business sector.

The demand for additional small business lending is there. There is just no way to adequately meet the need right now.

Our existing SBA 7(a) Loan Guarantee Program has been an invaluable resource, particularly as the credit crunch has hit small business so hard.

I want to note for the record that last week the Small Business Administration had to close its guaranteed loan window. It closed not just for a few days, but for the remainder of this fiscal year, unless and until a supplemental appropriation is enacted. Addition-

al funding was in the President's stimulus package, but it was not acted upon by the Senate.

We had $141 million in that package, which we passed in the House, which would have leveraged approximately $2.6 billion guarantee authority. Actually, that would have only taken us through sometime in August.

I have been working with Congressman Neal Smith, former chairman of this committee and chairman of the Appropriations Subcommittee. We are trying to get even more than that $180 million plus, to leverage $3.3 or $3.4 billion loan guarantees, which should take us to the end of this year.

We have to remedy that situation immediately. Jobs and our economic recovery is at stake. Small businesses cannot provide employment unless they have access to capital.

But as critical as that program is, continuing budget constraints will always preclude it from expanding sufficiently to meet the need. We just create new, innovative mechanisms to deal with this problem.

Today, representatives of some existing GSE's, or Government Sponsored Enterprises, will present their experience with Government-sponsored loan securitization programs, the advantages, the disadvantages, the costs, and the possible Government exposure.

We also have a witness from the Resolution Trust Corp., which is securing capital by securitizing and marketing the assets it has acquired. Again, I see a great similarity between the process the RTC is following and an approach I believe is feasible to increase small business financing.

It is somewhat ironic that these hearings are going on now. Much of the current credit crunch might have been avoided if we had a viable secondary market for small business loans without an express Federal guarantee, as is provided in the SBA program.

This is what Velda Sue is all about—a supplement for the SBA program, surely not a substitute. It would reduce the bulging demand for SBA financing, and it would do so without the need for additional Federal spending each time loan demand increased.

Today, we are pleased to have with us Ms. Jayne Shontell, Senior Vice President, Financial and Information Services, Fannie Mae; John Gibbons, the Vice President for Financial Research of the Federal Home Loan Mortgage Corporation; Henry Edelman, the President of the Federal Agricultural Mortgage Corporation; and Mr. Michael Jungman, the Vice President, Capital Markets, Resolution Trust Corp.

[Chairman LaFalce's statement may be found in the appendix.]

Chairman LaFalce. Are there any other Members who have statements they would like to make?

Mr. Zeliff.

Mr. Zeliff. Thank you, Mr. Chairman.

We have had many hearings now on the lack of credit availability, and it continues to be a major concern for small businesses.

New Hampshire is still suffering from the effects of a very difficult economic environment. Although interest rates are low and banks have money, small businesses are still experiencing many, many problems as far as obtaining loans are concerned. I am talk-

ing about qualified borrowers. Some blame the bank examiners; some blame Congress.

Small businesses are drowning in a quagmire of Federal regulation. Certainly our small businesses need our help.

We are here today to discuss secondary markets and Government-sponsored enterprise. While I support innovative ways to provide much needed credit for starting small business, I think we need to move cautiously.

Although I have reservations about GSE's like Velda Sue, I want to keep an open mind, and I am anxious to hear more information. We must not put Government in direct competition with our small- to medium-sized banks, or at least we need to be careful as we do that, and we need to know what the potential risk is for the American taxpayer in such programs as Velda Sue.

I am looking forward to this hearing to get some much needed information. We certainly need to resolve our credit crunch problems. If small business creates 82 percent of the jobs in this country, certainly we need credit availability to support the needs of small business.

Thank you, Mr. Chairman.

[Mr. Zeliff's statement may be found in the appendix.]

Chairman LAFALCE. Does any other Member have any opening statement they wish to make?

With that, we will hear from the panelists. We will put the entirety of your prepared testimony in the record if there is no objection. Without objection, so ordered.

I would ask each of you to either read it or summarize it in approximately 10 minutes.

Ms. Shontell.

TESTIMONY OF JAYNE J. SHONTELL, SENIOR VICE PRESIDENT, FINANCIAL AND INFORMATION SERVICES, FEDERAL NATIONAL MORTGAGE ASSOCIATION, FANNIE MAE

Ms. SHONTELL. Thank you.

Mr. Chairman and Members of the subcommittee, my name——

Chairman LAFALCE. This is a full committee.

Ms. SHONTELL. I am sorry. Mr. Chairman, members of the committee, I am Senior Vice President for Financial and Information Services at Fannie Mae. I have submitted for the committee's consideration a statement.

Fannie Mae was authorized by Congress, and currently exists, for the sole purpose of creating and supporting secondary markets for residential mortgages for low-, moderate-, and middle-income Americans. We do this by providing institutions that make or originate loans with a market in which to sell them.

At the end of the first quarter of 1993, we held $159 billion of mortgages in our portfolio, and we had $457 billion outstanding in guaranteed mortgage-backed securities.

Our total commitment to housing and housing finance comes from the mission stated in our charter and the vision and values that we hold. In our 1992 annual report to our shareholders, Fannie Mae's chairman, Jim Johnson, stated our commitment this way, and I quote: "The Fannie Mae I see ahead will lead in all as-

pects of housing finance in America, never forgetting we exist to serve the people of the United States and always mindful we represent interests of our shareholders whose capital makes our unique franchise work. We will always be faithful to the purposes of Fannie Mae's franchise, to provide stability and liquidity to the mortgage finance system at all times, and we will keep this faith because we know how indispensable we have become to the housing finance system, and those families who cannot afford decent housing without our help. There is a great trust placed in us that we will always honor and respect."

In 1992, Congress passed the most significant piece of legislation affecting Fannie Mae since 1968, the Federal Housing Enterprises Financial Safety and Soundness Act. The legislation creates a new regulator for Fannie Mae within HUD; sets tough new capital standards; and sets ambitious housing goals. We currently meet the minimum capital requirements of the new law, and we are fully committed to attaining the housing goals.

Among the reasons I was asked to testify today is my background in securitization. I spent 6 years at Freddie Mac in the early days of their PC Program, and I have been at Fannie Mae for the full 11 years of our Mortgage-Backed Securities Program. I was personally responsible for implementing Fannie Mae's REMIC Program.

Consequently, I have significant experience in creating and growing securities programs. Fannie Mae has programs to securitize and purchase single-family and multifamily mortgage loans, and its multifamily loans seem most similar to the commercial assets under discussion today.

Multifamily and commercial loans present more challenges because frequently there is not consistent, relevant, historical data on the loan's performance and documents. Loan structures are not standardized; they are backed by income-producing properties, and there is not breadth of nationwide credit experience for these loans. They are difficult to securitize, but they are doable.

There are four things that successful securitization programs have in common. First, they separate credit risk from cash-flows. These are two very different risks, and different expertise is required in dealing with each.

We deal with credit risk, we develop and enforce underwriting standards, and, as our experience grows, we refine those standards.

We have an incentive to take best practices and institutionalize them. Wall Street markets the cash-flows. They have the incentive to be creative and to develop proprietary products. Securitization permits each party to focus on what it does best: Bringing the two back together in partnership. Thus, the market for these securities grows, both because of homogenization of credit and financial creativity.

Second, they centralize securities issuance. This allows for high liquidity and continuous market presence. It translates into investor familiarity and confidence with a variety of players at every level of underwriting, trading, and selling.

Third, they build wide experience. Centralization has led us to unrivaled expertise in mortgage investing. It has enabled us to gather data on millions of transactions across all regions over a continuous period. Our high volume experience has made us more

efficient. We have, and our investors have, a high level of confidence in our abilities to evaluate and control risk.

Fourth, they homogenize diverse assets. Standardized assets are helpful but not critical to developing a securities market. Both our adjustable rate mortgage programs and multifamily experience were analogous to commercial lending in this respect.

Although underlying loans were diverse with distinctive credit risk documentation and cash-flow characteristics, we were able to issue $93 billion in single-family adjustable rate mortgage loan securities and $12.9 billion in multifamily MBS.

The critical factor was our ability to assess the differences, group like products and features together, standardize where it made sense, and create standards to help the market deal with differences.

Effective securitized secondary markets depend on two critical ingredients. First, a way of centralizing credit risk so the guarantor or insurer benefits from risk diversity over geographic boundaries and high volume; and second, adequate capital and scale of operations.

Adequate capital is necessary to protect investors from risk and to support the credit guarantees. Scale enables the issuer to develop operational economies which lower cost and benefit from risk diversification.

Much of our success as a company has come from the management focus we have directed to the task of competing in the residential mortgage market. By participating in one industry, we have developed the experience, expertise, and depth of understanding that are critical to corporate success.

Fannie Mae will be pleased to assist the committee as it looks for ways to support renewed strength in the commercial lending sector.

Thank you.

[Ms. Shontell's statement may be found in the appendix.]

Chairman LaFalce. Thank you very much, Ms. Shontell.

Our next witness will be Mr. John Gibbons from Freddie Mac.

TESTIMONY OF JOHN P. GIBBONS, VICE PRESIDENT, FINANCIAL RESEARCH, FEDERAL HOME LOAN MORTGAGE CORPORATION

Mr. Gibbons. Good morning. My name is John Gibbons, and I am the Vice President of Financial Research of the Federal Home Loan Mortgage Corporation, or Freddie Mac. It is a pleasure to appear before the committee today to discuss the success of the residential secondary market, particularly as it relates to the proposed development of a secondary market for small business loans.

I would like to commend the committee for this hearing.

While Freddie Mac, like Fannie Mae, is single-mindedly devoted to housing finance, we depend on the strength of employment, and the real engine of employment is small business. So, our concern with housing makes us very interested in the——

Chairman LaFalce. Mr. Gibbons, for the sake of the members of the Small Business Committee, could you explain the different reasons for existence for Freddie Mac as opposed to Fannie Mae?

Mr. GIBBONS. It is an historical difference in that Fannie Mae was originally established in 1938 for the purchase of Government-insured loans, which were the FHA loans, the great experiment in long-term financing for homeowners that made home ownership so——

Chairman LAFALCE. FHA guaranteed, VA guaranteed.

Mr. GIBBONS. Yes; that fueled the great growth in home ownership during the 1950's, alongside the FHA market that began to grow up in post-Second World War market, a conventional market, and the conventional market didn't have the same kind of success as the FHA market had.

In 1970, in expectation of the large cadre of potential homeowners moving into homes for the first time, Congress set up Freddie Mac to establish a secondary market for conventional loans.

At the same time, in 1968, Fannie Mae, which previously had been a Government entity, was separated into two entities, Ginnie Mae, which continued to do business, and Fannie Mae, which at that time was made a GSE to give support to the Government loan market.

In 1970, along with the establishment of Freddie Mac, Fannie Mae was given authority to make a market in conventional loans as well, so that, historically, Fannie Mae tended to deal with mortgage bankers and with Government insured loans.

Freddie Mac was a creature of the thrift industry and dealt with conventional loans. All of that, however, is probably just archaeology at this point, because the success of Fannie Mae and Freddie Mac has revolutionized the mortgage market and redone the way mortgages are made.

For all practical purposes, Fannie Mae and Freddie Mac serve the same purpose now, but serve it with a degree of competition that assures that the benefits of the Government charter flows to homeowners. The convergence of these two entities is a great success story because of the revolutionizing of the market and a healthy competition that makes the benefits flow to the American homeowner.

Chairman LAFALCE. I thought it would be helpful to have that.

Mr. GIBBONS. If I could just expand on that, in 1970 we were created by Congress to develop a secondary market for investment quality, conventional loans. At that time, there was a problem that had been diagnosed, which is not identical to the problem that we see now, but somewhat similar.

People spoke not of a credit crunch but of a credit gap. They measured it in billions of dollars, the difference between the supply of funds for mortgage loans and the demand. The demand was substantially outstripping the supply at that point.

The demand was outstripping the supply because there were geographic and institutional imbalances between supply and demand. To deal with these imbalances, depositories, thrift institutions largely, bought and sold mortgages among themselves. However, the mortgage market was far too illiquid to correct this mismatch, and there continued to be a credit gap.

Congress recognized the negative implications of this problem, and established Freddie Mac under the Federal Home Loan Bank

System to create a liquid market for conventional loans and increase the availability of mortgage credit.

The effect of this institution is not only to increase the availability of mortgage credit. By making the delivery of mortgage credit more efficient, the secondary market has lowered mortgage rates, especially in high-demand areas.

So, two principal functions of GSE's are first to provide a reliable source of funds, and second, a low-cost source of funds.

Chairman LaFalce. Can I point out that it has, in fact, lowered interest rates; is that correct?

Mr. Gibbons. Yes, it has.

Chairman LaFalce. This has been very good for the consumer, has it not? This has been of some concern to the traditional financial services industry because in lowering the rates to the consumer, they have a lower spread, do they not?

Mr. Gibbons. Yes.

Chairman LaFalce. Therefore, they have to work more aggressively to maintain their profitability. But this is in the interests of the consumer.

Mr. Gibbons. It is in the interests of the consumer.

If I could extend a little on the question of the concern of traditional financial institutions, I think there are a variety of ways in which the GSE's have lowered the cost of funds. One of the most important is that by being a reliable source of funding, we have permitted the origination of loans to be structured in a way that depends on that reliable source of funds, and let loose competition among the originators.

In fact, we have changed the way mortgage loans are originated, from origination largely by portfolio lenders to origination by specialists in origination, mortgage brokers, mortgage bankers, and the mortgage banking subsidiaries of banks that continue to be the largest originators. It is largely the specialization and competition that has lowered the cost of funds, not simply our superior access to the credit markets.

I think the comments that you had made on the SBA Program are pertinent in this regard. As long as you have only an unreliable stop-and-start source of funds, you are not going to get a loan origination system that develops, because people aren't going to make the investment in that kind of business system if it is going to stop and start.

What you have to have is a large institution which is always available, where people can build their business practices on the notion that it will be available, and compete to deliver to borrowers the lowest cost of funds in order to get the full benefits of a GSE, which flows from our making possible a highly efficient delivery system.

The secondary mortgage market serves borrowers by linking primary markets with capital markets. Mortgage originators sell mortgages into the secondary market and receive funds that can be used to originate more funds.

This process is invisible to borrowers. I think people here are familiar with Freddie Mac and Fannie Mae, but borrowers by and large are not. We do not displace the primary lender. We provide liquidity to the lender.

Mortgage-backed securities are valued by investors for their low risk and high returns. Institutional investors hold nearly 8 percent of mortgage securities with individuals holding a very small portion, up to 2 percent. The largest investors are banks, which hold approximately 24 percent, followed by life insurance companies, 16 percent, pension funds, about 12 percent, savings and loans, about 11 percent, and mutual funds, about 7 percent. Other holders of mortgage-backed securities are home loan banks, credit unions, individuals, and the GSE's themselves.

In other words, what securitization does is make credit available to the largest holders of funds these days, and makes the American home buyer able to compete for credit on the same terms as sovereign entities, supernationals, or the biggest corporations. To enhance the efficiency of the mortgage delivery system, Freddie Mac and Fannie Mae are exempt from certain Federal and State securities laws. This includes, to the same extent as Treasury securities, the exemption from blue skies.

I think this is an important point. When Congress established Freddie Mac, we were given a job to do, a mission, and limited tools with which to do it; access to the capital markets, but no funds. We have never cost the American taxpayer anything, and we are committed to never costing the American taxpayer.

Our ability to understand and price the credit risk of the mortgages underlying our securities is crucial to the success of the secondary mortgage market. Those risks in the housing area are minimized by a number of factors.

Mortgage pools are composed of very many small homogeneous mortgages. We purchase only mortgages below legislative loan limit, and all loans must either have a loan-to-value ratio of 80 percent or less or private mortgage insurance.

It is important to recognize that while we do focus on credit, credit in the housing area is considerably simpler than credit in the small business area. Our research shows the loan-to-value ratio, mortgage payment to income, and debt service to income ratios explains most of the defaults in residential mortgages.

These standard measurements of risk imply that the riskiness of mortgage-backed securities can be assessed and controlled with relatively little and relatively standard information. I think that is a difference between what we do and what a small business lender would do, and what makes it a real challenge for a small business lender. But we do have experience with something like business lending.

Freddie Mac's experience with our multifamily mortgages has not been as successful as with our single-family program. Measuring and quantifying the risk with these programs is much more difficult than for single-family loans.

When we initially embarked on this program, we did not do as well as we should have. In fact, we decided we had to get out of that market in order to reassess the proper way to do it.

We are now ready to reenter that market. But the difficulty of getting into a market that you have to get back out of means you aren't serving the real proper function of a GSE, which is reliability, always being there so that people can build their businesses.

Chairman LAFALCE. Fannie Mae has been in the multifamily loan market for how long, Ms. Shontell?

Ms. SHONTELL. We have been in it for over 5 years.

Chairman LAFALCE. You have had success?

Ms. SHONTELL. Yes; we are very pleased with the performance of our multifamily loan portfolio. It has been a slower growing market. It is a very critical piece of our ability to meet our housing goals, our affordable housing goals. We are very committed to staying in that marketplace.

Chairman LAFALCE. Of course, the past 5 years have been a difficult 5 years, too.

Ms. SHONTELL. As with the small business loan process, there would be a long lead time and a long startup process. The experience is something that is slow to develop, but it does develop, and then it starts to snowball.

Chairman LAFALCE. Is there some way that Freddie Mac can borrow from your expertise in some way?

Ms. SHONTELL. Fannie Mae and Freddie Mac have had discussions in underwriting standards and those kinds of things are in the public domain, and they are shared, and they are known.

Chairman LAFALCE. Even though you are competitors, both private corporations, both traded on the public exchange markets?

Ms. SHONTELL. Yes; we also see that it is very important to the secondary mortgage market for both entities, Fannie Mae and Freddie Mac, to have successful multifamily loan programs.

Chairman LAFALCE. Please continue. I am raising these questions because it is important to crystallize the issues at a certain point in time.

Mr. GIBBONS. Inferring the likelihood of success of the small business entity from the success of Fannie Mac and Freddie Mae has to be done with some care. It is certainly true that securitization gives a reliable source of funds.

Chairman LAFALCE. Long term?

Mr. GIBBONS. Long term, yes; long-term market, which is now going to be even more accessible than it was prior to the study.

It is also important to remember that the way Americans save has changed over the last few decades. Americans typically do not save through depository institutions but through pension funds, insurance companies, and mutual funds. These are the large sources of funds.

These entities do not want to spend a large amount of money underwriting particular investments. They want to be able to invest $100 million at a clip with a relatively small cost. You can't make that source of funds available to small business where localized underwriting needs to be done.

Basically, what securitization means is that a large investor can invest in a particular sector with the same ease that he can with a large corporation, or a Treasury bond or bill for that matter.

The principal lesson is the Government-sponsored housing enterprises have been successful because they address the underlying problem in an effective manner and carefully manage their credit risk.

A major hurdle, a major challenge for a small business secondary market will be to understand and control the risks associated with

guaranteeing these loans. Repeating the success for small business lending is a challenge that should be examined on its own merits.

This concludes my prepared remarks. I would be happy to answer any questions.

[Mr. Gibbon's statement may be found in the appendix.]

Chairman LaFalce. Thank you very much.

Our next witness will be Mr. Henry Edelman, the President and CEO of Federal Agricultural Mortgage Corporation, better known as Farmer Mac.

TESTIMONY OF HENRY D. EDELMAN, PRESIDENT AND CEO, FEDERAL AGRICULTURAL MORTGAGE CORPORATION, FARMER MAC

Mr. Edelman. Thank you, Mr. Chairman.

On behalf of the board of directors and the management of Farmer Mac, I want to express our appreciation for this opportunity to appear before your committee and provide you with information on the development of Farmer Mac and the relevant experience that we believe we have had that you may want to consider in the development of Velda Sue.

Farmer Mac, as you know, was created in 1987 by the Agricultural Credit Act to provide for a secondary marketing arrangement for agricultural real estate mortgages and rural housing mortgages, to increase the availability of intermediate- to long-term credit to farmers and ranchers at stable prices, and to increase the liquidity of the lending market for those borrowers.

We believe we have made a great deal of progress, though we have certainly had a slow startup.

Chairman LaFalce. Someone could say you were created to bail out a good many agricultural banks at the time.

Mr. Edelman. Well, I think there may have been that perception, and it has been one of the hurdles, Mr. Chairman, in the sense that some people believe that Farmer Mac was going to be a receptacle for the less attractive loans in the lending system. It took them a while to understand that the value of the program was in the securitization of quality loans rather than in the securitization of low-quality loans. I think that has been really traceable to your observation.

Under our program, we have a concept which is something that was started with Farmer Mac. It is the notion of having a pooler, external to the GSE, aggregate loans from originators, conforming loans for our program, and bring the pools together in a senior-subordinated structure so that there is a 10-percent minimum portion, which is not guaranteed by Farmer Mac. This provides credit enhancement to the 90 percent portion that is guaranteed by Farmer Mac.

The pooler, by bringing that portion to Farmer Mac, has already had to comply with our credit underwriting standards, our diversification standards, and our appraisal standards, which in turn were approved by Congress at the time we established them.

Those pools are reviewed by us. We use a stress test. If they meet our standards and withstand the stress test, we put our guarantee of timely payment of principal and interest on the senior securities.

Now, this certainly was designed with a mind to protecting the Government, and I think it works. It is a sound approach from the financial standpoint. On the other hand, the degree of complexity that it created for people who had not securitized loans before was a bit of an impediment to our startup and has continued to be one.

It might have been easier in many respects had Farmer Mac been the pooler with a provision that in the future other entities would be able to pool and bring loans to us for the guarantee.

Chairman LaFalce. There was no legislative requirement that you go outside to get poolers. You could have been the pooler, couldn't you?

Mr. Edelman. No; we couldn't, sir.

Chairman LaFalce. What was the difficulty?

Mr. Edelman. The legislation expressly provided that we could not be the pooler, that we would have to have external entities certified as poolers.

Chairman LaFalce. Has that been eliminated, that provision?

Mr. Edelman. No; it hasn't.

Chairman LaFalce. Should it be?

Mr. Edelman. We would certainly welcome that innovation. However, we have been able to make it work with that effectively enough so that today——

Chairman LaFalce. Why did they put that provision in?

Mr. Edelman. It is a long story that probably couldn't be covered in the few minutes we have here. I think there was some concern on the part of different people at the time Farmer Mac was being formulated, that it would become big so fast that it would suck up a lot of the very attractive loans that people might have liked to have held themselves.

Chairman LaFalce. It was the traditional financial services industry, investment banking community that led the opposition to your ability to pool?

Mr. Edelman. I think it was not any one particular group as much as a consensual notion among the larger aggregators of those loans for other purposes that they didn't want to give up some of their power.

Chairman LaFalce. Who?

Mr. Edelman. The insurance companies, the Federal Credit System, the banks, and they were concerned that we were going to overrun the market. I think we proved that concern was misplaced.

On the other hand, not being a pooler is problematic. As to what would have happened if we were the pooler, it would have been better. However, with that constraint we have been able to prompt——

Chairman LaFalce. With Velda Sue, we would permit either option.

Mr. Edelman. I think that is certainly an improvement. But living with that constraint, we have been able to prompt nine institutions to become poolers in the Farmer Mac Program over the last several years. Right now, two of them have programs in the market that are what we refer to as "open window" programs. That is, they are accessible to all lenders, who in turn would be accessible to all borrowers. In addition, they are providing long-term, fixed-rate loan products and intermediate-term loan products at

very competitive rates to all institutions that own Farmer Mac stock.

This is quite a development, not so much in terms of volume—last year's volume was about $600 million—but in terms of rate. The 15-year rate, for example, for a Farmer Mac fixed-rate loan, is comparable to the midstream of competitive rates being offered by large institutions, and it is available to every small lender who is a Farmer Mac stockholder, which is something every lender in the country could be.

So, I think that the important thing to observe about Farmer Mac is that we are really a special case of commercial loan securitization. Agricultural loans are indeed small business loans. We have been successful at securitizing those loans on certain terms and on developing a program which offers access to small institutions throughout the country, the community banks, the farm credit associations, other lenders, mortgage bankers, who want to participate in this program, without regard to their affiliation.

They could be an independent institution and still have access to large institution pricing. We think this is a very important development that Farmer Mac has been able to achieve. While I think that the senior/subordinated structure and the poolers have been millstones around the neck of the development of the program, they have certainly taken care of questions about safety and soundness and risk to the Government.

I think that the use of our linked portfolio strategy, that is, the matching of Farmer Mac borrowings to securities that we purchase ourselves, was an innovation I just want to spend a moment on.

In 1991, we found that the securitization of these agricultural loans was hampered by the lack of data on loan performance and also by the perception of the capital markets that loan prepayments would be really more sensitive than they could predict, because——

Chairman LaFalce. Loan prepayments?

Mr. Edelman. Loan prepayments would come with interest rate changes more readily than would have been the case in residential. I think that residential has become so intense on the prepayment side that maybe that is not as true today. But at the time people certainly felt that way. I think that as an ongoing proposition, that is still going to be out there.

That, coupled with the lack of any kind of reliable data about agricultural real estate loan prepayments, resulted in such potentially wide, mortgage-backed securities spreads that the pricing of the mortgages wasn't going to be competitive.

We looked at that and at the fact that there were other devices in the commercial lending arena and in agricultural lending in particular, such as yield maintenance and certain other prepayment penalties that were commonplace and had a lot of value the market would not fairly price. We came out with this strategy which was kind of a wrinkle in Farmer Mac. We said, "We are out there guaranteeing the senior securities. We might as well buy them." This could be done with no change in credit risk. The purchase could be funded with our own debt as long as we had adequate protection against the consequences of prepayment and interest rate exposure associated with it.

By developing linked portfolio, we were able to address a practice in the market that wasn't being fairly valued and come up with a product which creates very fair pricing for agricultural real estate borrowers.

So, that was a very important development for us in 1991. It resulted in a spurt of activity in Farmer Mac that also led to more reliability of pricing, so that people could see where Farmer Mac securities would trade and where we could price new loan originations.

Last year, Farmer Mac $600 million worth of business based on existing loans in lenders' portfolios. About half of those loans were recent originations designed for Farmer Mac, but they were nevertheless existing loans.

We then shifted to a program of pursuing new originations to try and generate new borrowing opportunities and more aggressively priced fixed-term, borrowing opportunities.

Chairman LaFalce. You began that when, in 1992?

Mr. Edelman. In November 1992. We referred to it as Project High Gear.

First, we established our pricing through existing loans. Then we wanted to shift into new originations. Now there are two Farmer Mac poolers, Travelers Realty and Prudential Securities, who are pursuing this type of program. They are both getting the kind of attention we would like to see from the lenders, and their portfolios of loans that are going to be securitized are growing. So, we are pleased with that.

I think, again, it is a learning experience. You can't expect people to figure this out immediately and start making lots and lots of loans tomorrow afternoon. It doesn't work that way. They all ease into it. It requires an adjustment of priorities, everything from internal management of the institutions having to go back and look at their managers of agricultural real estate loan portfolios and say, "All right, from now on we are not going to measure you."

Chairman LaFalce. What is the quantity of new loans securitized since November?

Mr. Edelman. There have been no new securitizations. However, there have been a fair number of loans that have been extended in the programs of these two poolers. We expect to see transactions with them by year-end of, perhaps, a couple of hundred million dollars each.

It really depends upon interest rate movements.

Chairman LaFalce. Who are the two poolers?

Mr. Edelman. Prudential Securities and Travelers Realty.

Chairman LaFalce. Any further comments?

Mr. Edelman. Yes; You had asked also what we thought the lessons of the Farmer Mac Program were. Obviously, we have touched on the question of the merits of having a pooler. I think another thing that is very important is that the use of a GSE and the use of a funding vehicle to bridge the gap between market perceptions and empirical evidence that can be used is very important.

I also think that if I had to pick one other item that was of great importance, it is diversification. The market looks for diversification. Even with the Farmer Mac guarantee, it is necessary to sell

the subordinated interest, and that has to be a diversified subordinated.

Congress was very wise in requiring diversification of Farmer Mac pools, and perhaps that might be something that is worth considering for Velda Sue.

Chairman LaFalce. You better not have any pool, if you don't have diversification, you are in trouble. Anything else?

Mr. Edelman. No; thank you for the opportunity.

[Mr. Edelman's statement, with attachments, may be found in the appendix.]

Chairman LaFalce. Thank you very much.

Our next witness will be Michael Jungman, vice president for Capital Markets for the RTC.

TESTIMONY OF MICHAEL A. JUNGMAN, VICE PRESIDENT, CAPITAL MARKETS, RESOLUTION TRUST CORP.

Mr. Jungman. Thank you, Mr. Chairman and members of the committee.

I notice a phrase Henry used, receptacle for less desirable loans. He was careful to point out that doesn't apply to Farmer Mac, but it is a pretty good description of the RTC. That is something that distinguishes the RTC from various Government enterprises.

Chairman LaFalce. You have all types. The institution is closed down, you have good ones, bad ones, and atrocious ones. It is a mix.

Mr. Jungman. Yes. We have diversity, too. The RTC launched its securitization effort in June 1991, with an offering of single-family, mortgage-backed securities known as MBS.

Since this initial offering, the RTC has securitized a wide range of asset types, including multifamily mortgages, commercial mortgages, second mortgages, meaning home equity loans, mobile home loans, and, in one transaction, high-yield bonds. With over $36 billion in securities sold since the program's inception, the RTC is considered in many quarters as not only a large issuer of mortgage- and asset-backed securities, but also as an innovative issuer.

The reasons for——

Chairman LaFalce. Before you go any further, when the RTC obtains these properties, you obtain them at quite a discount, do you not, from what their original market value had been?

Mr. Jungman. Well, the RTC basically obtains them at book value, and then the Government, through appropriated funds, pays the discount to market value, yes, sir.

Chairman LaFalce. All right. What is the book value in comparison to market value, as a general rule, the original mortgage value?

Mr. Jungman. It, of course, varies by asset type. For single-family mortgages, we are achieving——

Chairman LaFalce. Commercial property.

Mr. Jungman. For commercial mortgages, our experience in whole loan sales of commercial mortgages has been anywhere from 50 to 60 percent of face value. Our experience in securitizing those has been that we can recover somewhere from the high 80's to the low 90's as a percentage of face value.

Chairman LAFALCE. Is that 80 to 90 percent of the 50 to 60 or 80 to 90 of the 100?

Mr. JUNGMAN. Of the 100.

Chairman LAFALCE. All right. Please continue.

Mr. JUNGMAN. The reasons for the RTC entering the securities market are straightforward: Price, execution, and liquidity.

The basic value of any securitization process is to widen the pool of potential capital that is attracted to the pool of assets, and to include investors who would not otherwise be interested in those assets.

These are some of the same factors that have led many people to explore the relevance of securitization to the expansion of credit for small business. The RTC's experience in securitizing so-called hard-to-sell assets, in particular commercial mortgages and high-yield bonds, may prove useful to the committee as it evaluates the various options.

Let me state clearly that although the RTC has sold and collected $5.8 billion of nonmortgage commercial business loans to date, we have not securitized that particular asset category.

First of all——

Chairman LAFALCE. Of what relevance are those transactions to our consideration?

Mr. JUNGMAN. Well, I think there are similarities, certainly, between commercial mortgage securitization and nonmortgage commercial loans in terms of developing a secondary market for a type of asset that the secondary market has not yet seen.

We have done $8 billion of commercial mortgage securitization, but the nature of a nonmortgage commercial loan is quite different. Credit analysis is quite different, and it is another step beyond that to say it is possible to securitize nonmortgage business loans.

It would be incorrect for me to say that the RTC developed its program by itself. The RTC has been successful in this regard because it worked hand in hand with the private sector. The role of the RTC has been to use financial technology developed by Wall Street. In hindsight, our decision to build on credit enhancement devices and bond structures that were developed for private sector issuers, we think was the correct one.

For example, the RTC's first single-family issues were very similar to issues that were done by thrifts and mortgage companies in the private market. In other words, we tapped into an already well-defined secondary market.

The reps and warrants, the ratings, the bond structures were all familiar to investors. Not only did this facilitate the marketing of the bonds, it also saved money for the taxpayer, because the RTC was able to come to market very quickly without the need for legislative or regulatory action.

Second, the RTC has benefited from a relatively well-developed tax and legal infrastructure. The availability of SEC shelf registration for residential MBS, and more recently commercial MBS, has provided investors with full disclosure while minimizing the time and legal expense necessary to publicly market the securities.

The existence of acts passed by Congress, such as the Secondary Mortgage Market Enhancement Act of 1984, has simplified the process of offering securities in many States. The creation of a spe-

cial body of tax laws for mortgage-backed securities, the Real Estate Mortgage Investment Conduit Act of 1986, has been especially important.

The REMIC rules have helped eliminate many of the tax problems associated with pooling individual mortgages into securities while providing clarity to investors as to the tax treatment of the resulting instruments. This body of securities and tax laws is not now wholly available for nonmortgage business loans, which may complicate the structuring, marketing, and purchase of securities backed by those loans.

Third, the RTC has benefited from preexisting regulatory capital treatment for many of its securities. For regulated depository institutions, it is advantageous to invest in residential mortgage securities, as the institution has to hold less capital to support those investments. As this makes the securities more attractive, issuers can pay lower yields than on securities of comparable ratings and duration, such as commercial MBS, that lack more favorable capital treatment.

None of these factors were developed solely for the RTC. The RTC simply adapted what was available to fit our own needs. Most importantly, we did it in a fashion that did not rely on Government guarantees. The use of Government credit guarantees undoubtedly would have brought faster execution and better prices, but it would not have helped private markets as much, and it certainly would have raised other difficult public policy questions.

The RTC has shown what can be done in the area of securitizing commercial mortgages and one need only read the financial pages to see that the private sector is now following what the RTC has done. For example, there has now developed an active market for debt securities backed by nonperforming commercial mortgages that many banks, thrifts, and insurance companies are beginning to use to liquidate their nonperforming loans and REO.

The RTC's experience in securitization probably is more similar to that of private sector issuers than it is to the experience of Fannie Mae, Freddie Mac, and the other GSE's. As noted above, the RTC has relied on reps and warrants, ratings, bond structures, and credit enhancements that are of a type typically utilized by private sector issuers. The GSE's, in contrast, enjoy the perception of an implied Government guarantee that makes many of those factors less important. Accordingly, RTC MBS price and trade at levels comparable to private issuers. In addition, the GSE's are able to control the quality of their collateral by imposing stringent criteria. The RTC, as noted earlier, has no control over the quality of the loans in its inventory and has to compensate for the poor quality of the asset pool with higher levels of credit enhancement and other structural features.

The challenge of securitizing commercial business loans is, in a technical sense, as great or greater than the one faced by the RTC in securitizing its mortgages. In large part, this is due to the nature of the asset. For some types of business loans, the appropriate credit analysis is much more complicated than it is for others, and credit rating agency criteria for that analysis are much less developed. The servicing is complicated because most commercial loans, or many commercial loans, take the form of a line of credit,

which means that the principal balances can change radically from month to month as the borrowers either make payments to, or advances against, their line of credit. The complexity of the asset is compounded by the lack of a clear legal and tax infrastructure available to support its securitization.

In conclusion, the RTC's experience shows that it is possible for a Government entity to expand the secondary market for securities backed by unusual assets without the use of Government guarantees largely by coordinating with the private sector in developing the necessary framework.

I have to point out again, though, that for nonmortgage commercial loans, you do not have the same legal and tax infrastructure. It simply doesn't exist at the present time.

I would be happy to answer any questions that you may have.

[Mr. Jungman's statement may be found in the appendix.]

Chairman LaFalce. Thank you very much.

Since 1984, I have been promoting the development of the secondary market for small business commercial and industrial loans. I have taken different stances throughout the years. I started with something called FIMA, the Federal Industrial Mortgage Association, and I have evolved to the point where I am now discussing a GSE, called Velda Sue.

Are we onto something here? Is there a need? Shall we continue pursuing this? Could this be very important to the small business community, to marry them up with lenders that they traditionally don't have access to; insurance companies, pension funds, et cetera?

Ms. Shontell.

Ms. Shontell. Mr. Chairman, I am a great believer in the power of securitization. I think that what a GSE and securitization can bring to small business loans is a central place where experience can evolve, where knowledge can evolve, where the credit risks can be focused on by people who develop a lot of experience, and the ability to bring a special purpose together with funds from all over the country, every kind of financial sector.

What the GSE's do is promote efficiency, and they allow funds to move from where they are available to where they are needed.

There continues to be roles for those institutions, like banks, that have the knowledge to originate these loans and——

Chairman LaFalce. To service them.

Ms. Shontell [continuing]. To service them, absolutely.

Chairman LaFalce. We must not forgot the service component. Not nearly as important for a residential mortgage as it is for a business loan.

Ms. Shontell. It is also important for a residential mortgage, and I didn't mean to gloss over that.

Chairman LaFalce. There is quite a market for the sale of the servicing of residential mortgages. While I have some difficulties with that, they are not so great that I would say you must maintain the servicing. I would have tremendous difficulty if people wanted to start selling the servicing of business loans, particularly the small business loan.

Ms. Shontell. The thing that the GSE brings to the table is focus on diversification, by bringing together loans from all over

the country, the development of credit expertise, and the ability to tap the capital markets consistently, and in a way that investors will get to know the product, and know who they are buying from.

Chairman LaFalce. Talking GSE now.

Ms. Shontell. Yes.

Chairman LaFalce. That goes to the second question. The first question I still want answered is, Are we on the right track?

The second question is, 10 years ago people said, "Oh, great idea; you are on the right track but you don't need a GSE; the market will do this by itself." Well, it hasn't and people are still saying that today.

I personally don't think that small business loans, the market, will do it by itself. Oh, they will go an inch or two. You might be able to get loans from French IZ's and pool them, but I don't think you can get very far with a small business without a GSE.

Ms. Shontell. I believe the GSE will facilitate the market moving in the most efficient direction.

Chairman LaFalce. Mr. Gibbons, two-pronged question.

Mr. Gibbons. I certainly do think that this is very important and you are on to something.

It is interesting to look at a variety of different kinds of lending to see whether a secondary market has arisen and whether it has required a GSE. While we here represent markets in which GSE's have been active, you have also seen, over the same period, a very active secondary market grow up in auto loans, credit card loans, and so forth, which have been developed and become vibrant. The typical way of financing——

Chairman LaFalce. You have tremendous collateral.

Mr. Gibbons. Right. So, what you can say is the market will take care of some things, and in that case it is not only the collateral, but it is also the fact these markets grew up through the issuance of investment grade entities who are using securitization as an alternative way of funding themselves and accessing the large sources of funds that was lower in cost than their debt. So that if you have a situation where the originators are very large entities, just looking to fund themselves in a different way, then the market is likely to work by itself. In those cases, uniformity is not that important.

It seems to me, you need a GSE if only a GSE can provide the appropriate diversification and provide the kind of standardization and uniformity that is required for securitization. That may well be the case with small business lending. You also require a GSE, I think, if servicing is a very important matter.

Now, I want to focus on this. GSE's are noted for standardization and that is——

Chairman LaFalce. The GSE would not do the servicing?

Mr. Gibbons. Right, it would not do the servicing.

Chairman LaFalce. It would ensure the servicing be done?

Mr. Gibbons. Yes; but in the private market, the owner of the assets is actually a trust, and when a trust owns an asset, there is very little mechanism for its working things out with the borrower.

One of the difficulties with the purely private market is that you will have trust indentures of things. For example, if the borrower

gets in trouble, you foreclose on them and throw them into bankruptcy; you cannot have that in small business lending.

Chairman LaFalce. One of my problems with one proposal in the other body is how everybody is involved except the small businessman.

Mr. Gibbons. A GSE has the ability to introduce both uniformity that makes possible a wide market and the flexibility to make sure that individual borrowers are appropriately treated, and that when problems arise they are worked out.

You don't want to institute a system where money is freely available but the first time the payment is missed, the borrower is thrown into bankruptcy. That would not do anybody any good. I don't know how you get around that in the purely private market. I think it would be rather tough.

One of the things bankers say is, you have to control the credit to work with the lender. I think there is a lot of wisdom in that and it is compatible with the GSE. It is very difficult to make it compatible with the purely private market solution.

Chairman LaFalce. Mr. Edelman.

Mr. Edelman. I think you are on to the right thing for a couple of reasons, several of which were already touched upon, but a few others.

I think you can achieve greater availability of credit and more competitive pricing by giving to smaller lending institutions, and a broader diversity of lending institutions, access to competitively priced funding by being able to sell those loans.

Also, give them access to long-term, fixed-rate funding by selling the loans. A lot of institutions, depository institutions, do not have access to long-term, fixed-rate funding and cannot make long-term, fixed-rate loans to small businesses, which I think is a significant competitive——

Chairman LaFalce. Small businesses don't get long-term or fixed-rate loans.

Mr. Edelman. Velda Sue could certainly accomplish that, which is extremely important.

Another thing is the bridging of an information gap. That is, when you look at small business loans, it is much harder to generalize about them than it is about residential mortgages. There are different SIC codes and subgroups of business loans.

We have faced one corner of that in the securitization of agricultural loans. How do you come to terms with the diversity of loan characteristics in the real world and the need for standardization in order to securitize?

I think that will be an important challenge. But we have demonstrated it can be overcome, and in our program we have been able to securitize many different types of agricultural loans without having entirely standardized documentation.

I think you can achieve that with a GSE where it might not be achieved without one. The examples you used—automobile loans and credit card loans—you can add boat loans to that and several others, mobile homes, all have largely standardized documentation and fairly good data bases.

It is much harder to talk about that when it comes to small business loans, and a GSE would perform a very important function

there in consolidating and balancing a diverse group and finding an alternative to the extensive documentation on these other types of loans.

Maybe the last thing is the point John was making, which is flexibility. Learning how to balance the different credit qualities of a group of loans is very important, and being able to administer them with flexibility is important.

That can only be achieved with large groups of loans that are diversified so that they don't all sway one particular way in the wind. I think, therefore, Velda Sue, as a concept, is a very sound one.

Chairman LaFalce. Mr. Jungman.

Mr. Jungman. Mr. Chairman, I think there is no question that the creation of the GSE would stimulate the flow of credit to small businesses. I also think, however, that the private market would get there, not as quickly perhaps, but they would get there with the kinds of regulatory and tax changes that have been made applicable to mortgage securitization. It would be a slower process, though, there is no question about that.

I would like to refer to Mr. Gibbons' remark on servicer flexibility. That is an issue that we have dealt with in the RTC's commercial mortgage securitization program in considerable detail. Those transactions have a master servicer, which performs the normal loan servicing functions of collecting payments, monitoring the borrower, and so forth. They also have a special servicer, who deals only with loans that are in trouble. That special servicer has the flexibility to do anything that they think, in their judgment, will maximize the net present value recovery from that loan. That includes foreclosure, but it also includes restructuring the loan terms and turning it back into a performing loan, if possible.

The way that we are able to entrust that kind of flexibility to a servicer is by structuring their compensation as if they owned an equity interest in that loan. In effect, they get a greater share of recovery out of the reserve fund if they maximize the net present value of the loan.

So, that is just one example of the kinds of structures that can be developed in securitization in the private sector to address those issues.

Chairman LaFalce. Thank you very much.

Ms. Shontell, you wanted to follow up?

Ms. Shontell. If I might just add one comment. I think the private sector could very well develop some of this market on its own, and maybe it is, and maybe it will. The thing a GSE does, though, is consistently in that market, through bad times and good times, and it is in every market geographically across the country, the private sector will pick the markets——

Chairman LaFalce. Cherry pick.

Ms. Shontell [continuing]. It wants to participate in, and it will pick those markets during very good times.

So, if you are really looking for something to solve a problem and to stimulate new lending, I think that the private sector needs to be worked with. It needs to be led. They will bring a lot to the party. They will contribute quite a bit, as they have in the mortgage market.

Chairman LaFalce. You have a lot of competitors in the private sector.

Ms. Shontell. Right, and we have had in the past 10 years, even in mortgage lending markets in the country, where the private market would have left, the GSE's stayed and serviced them, and we are able to service them because of the diversity of the assets that they were servicing overall.

Chairman LaFalce. Mrs. Meyers.

Mrs. Meyers. Thank you, Mr. Chairman.

I have had some concern about GSE's over the years, and I think you have all done a good job, but I really am concerned about the amount of exposure to the taxpayer.

What is the exposure to the taxpayer in Fannie Mae, Ms. Shontell?

Ms. Shontell. The exposure to the taxpayer would be if Fannie Mae were not conducting its business properly and Fannie Mae's capital were gone through, there are certain lines of credit with the treasury that Fannie Mae has that it could borrow on.

But what really happened last year with the passage of what we call the GSE bill, the Safety and Soundness Act, was that certain regulatory structure was put in place that enabled the regulator to step in when early warning signs were felt. There are different levels of capital that are required, and, if the GSE falls below one of those levels of capital, the regulator can come in and start taking increasing amounts of control over the company.

The other thing is that what we are dealing with are assets that are in and of themselves very valuable, and they are being underwritten by very high standards. Those standards are public knowledge.

There is a lot in the marketplace that validates what we do. I think that is really the comfort, both the Safety and Soundness Act, the capital levels that are within the company, the quality of the asset that the company deals with, and the track record that the company has in terms of earnings.

Mrs. Meyers. Mr. Gibbons, what is the exposure to the taxpayer?

Mr. Gibbons. Freddie Mac currently has about $400 billion in mortgages, and the exposure is that in the event of a severe protracted deflation in housing prices, the value of those mortgages may not be sufficient to cover the debt.

I think it is probably worth saying that the taxpayer is protected in three ways. First, by our capital, which is currently about $4 billion.

Second, by the quality of our portfolio. The average loan-to-value ratio of our portfolio is in the mid-60's, which means that our $400 billion in mortgage loans, secured currently by about $700 billion in single-family homes, so that the single biggest protection is the home equity of the homeowners who own those homes.

The third is a very, very rigorous capital requirement and regulatory structure where the specific thing that would expose the taxpayer to risk, which would be severe housing deflation, is used as a framework for assessing the adequacy of our capital.

Would you be able to survive 10 years in the presence of a more severe deflation than we have seen? If you cannot, you immediately at that point have to recapitalize yourself, so that you have a

very tough, forward-looking capital requirement with a regulatory structure that says, see if you can survive that, and if you cannot, you have to get back to a situation where you could survive it.

So, yes; there is exposure to the taxpayer, but the primary protection is risk management, adequate capital, and an excellent regulatory structure.

Mrs. MEYERS. Still, the foundation was shaky enough that we did have to call for more vigorous capital standards in the GSE Act of last year or the year before. You feel like you are much more sound now and more solid?

Chairman LAFALCE. If you felt you were sound before, you are even more sound now.

Ms. SHONTELL. We have always felt sound. The moment the legislation passed, we met the minimum capital standards. So, it wasn't as though we were deficient.

I think what the legislation did, though, is it formalized a structure for insuring the safety and soundness that had not been in place before, but I think the GSE's had been functioning in a very safe and sound way and had the capital to support that.

Mr. GIBBONS. Immediately prior to the passage of the legislation, we raised $565 million in preferred stock. We had not, prior to 1990, had access to the capital markets because we were a creature of the Home Loan Bank System.

All of our capital was internally generated, and it wasn't until the passage of FIRREA that we had any access to the capital markets. So, I think we felt we were sound, but we felt that now that there was an opportunity to have access to the capital markets, and, in light of the pending legislation, we ought to go to the capital markets. We are half a billion dollars stronger in capital than we were a year ago.

Mrs. MEYERS. Is there not an additional risk factor in Velda Sue because you are talking about not only the value of a property, but the diligence, effort, and ability of business people, and so this is even riskier to the taxpayer than Fannie Mae or Freddie Mac?

Chairman LAFALCE. Can I respond?

Mrs. MEYERS. Yes; of course.

Chairman LAFALCE. Well, the answer is clearly yes. I mean, that is one of the reasons that the risk-based capital standards, that were agreed to in Basel, Switzerland, demands more capital for small business loans than they do for residential mortgage. That is why banks are inclined to give residential mortgages much more readily than they are a commercial loan.

It also points out the greater need for some Government-sponsored enterprise, as it points out the greater need for Small Business Administration loan guarantees.

Now, if you want to compare exposure of the Government, the exposure of the Government under a SBA loan guarantee I don't want to say is infinitely greater, but is considerably greater than an exposure you would have under a privately chartered but Government-sponsored enterprise where there is no direct governmental guarantee.

Mrs. MEYERS. Still——

Chairman LAFALCE. So, in other words, whenever we say let us have an increase in the SBA loan guarantee authority, we are ex-

posing the Government to far, far greater risk than we would ever be doing if we created a GSE.

Mrs. MEYERS. Well——

Chairman LAFALCE. I wanted to make that clear.

Mrs. MEYERS. Still, it is subject to appropriation, and I know that the thrift industry was very sound as long as it was regulated and as long as it stayed very close to loans for homes. When it began to expand and speculate in businesses, oil and gas, other riskier ventures, we have seen what the exposure to the taxpayer was.

Mr. Jungman, is there concern, do you have some vague concerns about what Velda Sue might mean to the taxpayer?

Mr. JUNGMAN. Well, I think it is a different kind of credit to analyze. I think that there is no question that it is a tough problem. There are well-recognized standards for mortgage lending, both residential and commercial.

Small business loans, however, tend to be more individualized. In many, many cases it is the banker looking at the businessman or woman across the table and making, in many ways, a subjective judgment about that person's ability.

So, I think it certainly presents challenges that need to be taken into consideration. These are going to be tough loans to standardize and analyze and have a high degree of confidence in what the loss projections are going to be.

Mrs. MEYERS. I am sure that all of you are affected by major changes in valuation in property that take place for different reasons. In California, right now, it is because California has been so dependent on defense industries, and now that the defense industries are no longer, their homes that were worth a half million dollars cannot sell.

The 1986 Tax Act, although I voted for it, and I think it was something we had to do, and it was important, it made major changes in real estate values and ended some speculation that I think had inflated the value of real estate out of all proportion to its actual value.

That is not to blame anybody. I am sure those changes in the tax code in 1981 were done for good reasons. I was not here at the time. I am sure that deregulating the thrifts was done for a good reason. I was not here at the time. But the whole thing did inflate real estate values out of proportion to its actual value, and then certainly a succession of bad agricultural years can affect the value of farmland drastically.

So, how are you all affected by these kinds of major changes that you really cannot control?

Ms. SHONTELL. They happen, and sometimes they happen in very big ways. They happened in the Southwest in the mid 1990's. To a very large extent, they are happening now in parts of California and parts of New England. It is sound underwriting and sound business practices and having something at risk in the transaction.

That is what the capital supports. That is what the homeowner puts in terms of a downpayment, to help see that the homeowner has some risk in the transaction; that there is a cushion to help absorb some price depreciation, and it is also what the capital of the institution is there to help absorb.

What the diversity does for the GSE is it helps. One fortunate thing is not all areas of the country tend to be affected as severely at the same time. So, the blows become somewhat mitigated by the other parts of the country that are performing well. It is that aspect of diversity, in terms of managing credit risk, that becomes very, very important.

Mrs. MEYERS. In terms of a Velda Sue, Ms. Shontell, when the entire country is affected by a slowdown in a recession, such as we have just been through, what would you expect the impact would be on a Velda Sue?

Ms. SHONTELL. I am not experienced or expert at all in commercial lending and in the making of small business loans. Without a doubt, whenever there is recession, delinquency rates go up. That is true in mortgage loans, and it is true on business loans. It is exactly that which we reserve against; that we try to protect against for the event when it happens.

I would assume that Velda Sue would be set up in such a way so that not only does it have capital but that it reserves, and that it uses structures that will help protect and weather that kind of increase in delinquency rates and default rates when the economy turns down.

Mr. EDELMAN. I wonder if I could respond on the points about agricultural loans and also protection to the Government in a commercial loan securitization program like Farmer Mac or Velda Sue.

First of all, the additional concept of using a subordinate. This means not only do we have a stress test, minimum capital requirements imposed upon the GSE and the borrower's own equity, which in Farmer Mac must be at least 25 percent and, as a practical matter, has been running about 35 percent, we also have a subordinate which absorbs the first risk of loss up to 10 percent on a pool-wide basis.

So, that means you would have to have roughly three or four times the worst case of losses in a diversified pool of loans, and we have run this backward in time, in order for Farmer Mac to start sustaining losses to its own capital.

That is a very important distinction about Farmer Mac. Velda Sue has a similar but different provision in it. That is very important for you to keep in mind in comparing commercial to residential.

The other thing is that in the appraisal of commercial loans. At Farmer Mac, one of the key elements that got agricultural lenders in trouble in the mid-1980's has been anticipated, which is that every appraisal must contain not only a consideration of market price, the upward spiral trap, but also of replacement cost. The most important thing is the present value of the income stream from the property. That is, "Is this property being valued at the fair market value of the income it could produce over its life?"

If it is being valued above that level, then we would have a real problem with the loan. On the other hand, if it is being valued at a level that fairly takes into account its income-producing potential, then——

Mrs. MEYERS. You mean if you had been in existence in the early 1980's.

Mr. EDELMAN. Yes.

Mrs. MEYERS. When everybody who lived in the city was buying up farmland, because you could have limited partnerships and write it all off and double your money and all that, you would still have made——

Chairman LAFALCE. It was a 1981 tax law, not 1986.

Mrs. MEYERS. No, it was——

Mr. EDELMAN. Not only would we still be in existence, but there was extensive testimony in September 1989 that had Farmer Mac been in existence during the farm credit crisis of the mid-1980's, it would have had much less impact on the borrowers. There would have been fewer foreclosures, there would have been fewer closings of banks, and there would have been fewer significant losses to lenders during that period.

Mrs. MEYERS. Why do you think that would have been?

Mr. EDELMAN. Because there would have been less concentration of losses. There would not have been lenders who were exposed to limited numbers of crops and limited geographic areas where there were particularly severe losses.

In the State of Iowa, for example, land values went down in some areas as much as 55 percent. However, there were other parts of the country where the impact was much less severe. Had those loans been pooled in a Farmer Mac structure, we had extensive testimony by all segments of the lending community that the impact on them would have been less.

Chairman LAFALCE. If I may interject here, just to augment the answer that was given, let us suppose you could have sold off a good percentage of your loan and you would not have been required to have capital against those loans. You would not have had reserve requirements. All those loans impaired the capital ratios of those financial institutions and, oftentimes, meant they could not make additional loans or they had to be closed down.

Whereas, had there been a secondary market, and they could have sold off either the entirety of the loan or portions of the loan, they would not have had to reserve against them, their capital ratios would not have been impaired, and they would have been able to make more loans.

So, I don't think there is any question whatsoever that had we had such an entity in the mid-1980's, a good amount of the great difficulties so many of our agricultural States had would have been ameliorated considerably.

I also don't think there is any doubt that had we had a Velda Sue from 1989 to the present, we could have ameliorated considerably some of the problems, especially in certain regions of the country.

Mr. EDELMAN. I think that also if Velda Sue adopts appraisal standards which adequately take into account the need to focus on the income-producing potential of the property, it would be a very important addition to the safety and soundness of Velda Sue and quell question of whether the taxpayer would be at risk ultimately on the properties. I think that following that kind of an approach would make Velda Sue not only a sound institution but also would improve the quality of lending generally.

What we have seen, for example, is we' have had people who have been resistant to the notion of selling loans because they have

not fully understood it. With respect to agricultural loans, they come to us and say that the Farmer Mac underwriting and appraisal standards have been very helpful to them in improving the quality of their portfolios.

So, not only will Velda Sue benefit the taxpayers directly by providing a secondary market, it will also set the tone for the standards in industrial and commercial lending and, perhaps, avoid other financial problems outside of the secondary market.

Mrs. Meyers. Do you agree with all this, Mr. Jungman?

Mr. Jungman. I think that there is an exposure to the taxpayer that you referred to before, and careful consideration must be given as to how best to protect the taxpayer.

For example, the analysis that the rating agencies do on the RTC's commercial mortgage securities are designed to produce reserves that will let them withstand extended economic scenarios similar to the Great Depression. So, we actually set aside cash intended to support the securities, in the event that the country goes into an extended Great Depression type of situation. It takes a lot of cash to do that. We have currently $6 billion in cash reserves set aside against some $36 to $37 billion in outstanding securities, which is 16 percent or so. We certainly don't expect the losses to run that high. We expect the losses to be only $1½ to $2 billion, based on our best projections of those particular mortgage pools.

But in order to get what the market will perceive as a double-A or triple-A rated security, you have to have that level of credit support underneath those securities. So, if you create a Velda Sue, you should probably be thinking in terms of capital support or reserves or some kind of backup, or those levels of protection to ensure the losses do not ultimately come back to the taxpayer.

Mrs. Meyers. OK.

Mr. Gibbons. Can I take a slightly different tack from my colleagues? I think we are all proud of our capital and all proud of our risk management, but we don't want to say there is no risk. All lending is risky and, in particular, in the small business area, that is good.

Small business is an engine of progress and of jobs because people take risks. They don't always pay off, and so there is failure.

But the questions that you have raised, I think, look more at the riskiness of the lending than at the particular risk of the GSE, because the riskiness, for instance, of real estate lending, which depends on the price of lands and can be affected by tax changes, somebody is going to bear that, whether it is a bank or a finance company or a GSE. I think the hard question is, who is in the best position to bear it in a way that does not expose the taxpayer?

The taxpayer is exposed whether a bank bears that risk or a GSE bears that risk. So, the question is, who is in a good position to manage that risk best, most efficiently, and with a minimum of exposure to the taxpayer?

I think the example of real estate lending indicates that there are advantages to GSE's. Anybody who has been a real estate lender just in New England, or a real estate lender just in the Southwest in the mid-1980's, and New England in the late 1980's, and, perhaps, California today, would probably be in very tough

shape. GSE's, because of national diversification, can weather those downturns.

So, I think that is an argument in real estate lending, that the diversification of being a GSE is an advantage. I think it is an open question whether that is the case in small business lending.

The question is whether local banks are in the best position to bear that, whether there is some advantage in diversification that comes from lines of business, or whether specific and national diversification means a GSE possesses less risk to a taxpayer than a deposit insurance fund and small business lending by banks.

Mrs. MEYERS. Thank you, Mr. Chairman.

I would like to ask unanimous consent to enter my opening statement into the record, which I did not get here in time to deliver because I had a group of constituents in for a breakfast this morning, and I am sorry that I was late.

[Mrs. Meyers' statement may be found in the appendix.]

Mrs. MEYERS. I want to thank you all. As you can tell from my questioning, I have a real great concern about further exposure by GSE's, and, in fact, I was very concerned for the ones that we have. Evidently they weathered the storm and are very solid, but I was concerned last year especially for Freddie Mac, and I appreciate the opportunity to question.

Chairman LAFALCE. I thank the gentlelady always for her insightful questions.

Let me pursue the question of the risk associated with GSE's.

Ms. Shontell, has Fannie Mae ever lost a dollar to the taxpayer? Has the taxpayer ever had to pay a dollar because of Fannie Mae's existence?

Ms. SHONTELL. No.

Chairman LAFALCE. Approximately how many jobs do you think have been created? How much of a contribution to GNP has been made, without the loss of one taxpayer dollar, through the activities of Fannie Mae?

Ms. SHONTELL. Those are interesting questions, and I would like to try to get back to you on those.

There have been 8 million people whose mortgages have been purchased. There are at least 2,800 employees of Fannie Mae nationwide whose jobs were created, but there are a whole bunch more in the building industry and in the lending industry.

Chairman LAFALCE. I would ask that you get back to us with that information, not having lost one taxpayer dollar in your how many years' history?

Ms. SHONTELL. We have been in creation since the 1930's. We have been private since 1968.

Chairman LAFALCE. All right, good.

[The information was not received.]

Chairman LAFALCE. What about Freddie Mac, Mr. Gibbons? Has the taxpayer ever lost a dollar on Freddie Mac?

Mr. GIBBONS. No; the taxpayer has never lost a dollar.

Chairman LAFALCE. About how many jobs do you think you have created? What contributions have you made to the GNP?

Mr. GIBBONS. Again, I would like to get back to you.

[The information was not received.]

Chairman LaFalce. Interesting, too, to point out what depressions would have been created in the United States had you not existed.

Mr. Gibbons. Between us, Fannie Mae and Freddie Mac pay approximately 1 percent of the corporate income tax in this country.

Mrs. Meyers. Well, I——

Chairman LaFalce. Let me ask this. If we didn't have a secondary market, and that is why we created you to deal with conventional loans, how much greater would be the exposure of the Federal Government if we had to proceed under a direct governmental guarantee program, such as FHA, VA, et cetera? Would the exposure be twice as great, 3 times as great, 10 times as great, 100 times as great, 1,000 times as great?

Since you would be dealing on an ad hoc basis for each and every individual loan via a governmental guarantee, you certainly would have lost Federal money, would you not have?

Mr. Gibbons. I think the direct lending programs in the housing area are meant to be actuarially sound.

Chairman LaFalce. But there is a certain loss—one of the reasons we have to come up with a subsidy for an SBA guarantee is because you have a certain individual loan loss that you must experience, and you must pay for that up front with a subsidy.

I said earlier we had $141 million and leverage $2.6 billion. The reason we come up with $141 million is to deal with loan losses. So, the taxpayer loses money to that extent through that program.

But in your privately created and now publicly owned GSE, there have been no taxpayer dollar losses at all—you paid back any subsidy that was initially contributed; is that correct?

Mr. Gibbons. Yes; we initially capitalized through the FHLBS and retired the initial common stock.

Chairman LaFalce. I think that is important to point out. Under our SBA guarantee program, we pay taxpayer dollars to deal with the individual losses that will be experienced under the SBA guarantee program. That is not true under the GSE's.

Anybody else want to add to this?

Mr. Edelman. I think your point earlier, about the greater capital strengths of the institutions that might have resulted had Farmer Mac existed when lenders were running into problems in the mid-1980's, also applies to Fannie Mae and Freddie Mac and, hopefully, to Farmer Mac, and Velda Sue in the future. Were it not for Fannie Mae and Freddie Mac, there might have been concentrated bank failures in certain areas that were even more severe than they were in the 1980's. Instead, those banks did not keep the loans on their books but sold them to Fannie Mae and Freddie Mac.

Another point in this regard is that interest rate risk management—the difficulty of making the long-term, fixed-rate loans needed by businesses, and funding them with short-term borrowings—is a serious problem. A lot of the problems that the S&L's ran into in the late 1970's and early 1980's are traceable to making longer term, fixed-rate loans. Interest rate management, interest rate risk management is dealt with by the GSE's.

The GSE's write to a zero-loss expectation. They don't expect to take a loss on credit; they don't expect to take a loss on interest

rate risk. I think that Velda Sue could certainly provide the same kind of support so that lending institutions could provide long-term, fixed-rate loans to borrowers without taking credit risk onto their books.

I think that the point about risk to the Government has to include the lending institutions, and Velda Sue would help those institutions——

Mrs. MEYERS. Would the gentleman yield?

I think my concern has been colored by my experience since I got here. I got here in 1985, and no sooner did I get here in 1985 than I knew we had a crisis on our hands with the S&L's.

Now, that happened first. Then we began to hear about some capital problems with the GSE's. We had a number of bank failures, the farm credit system was greatly threatened, and we had to restructure the entire farm credit system.

All of that is an enormous exposure to the taxpayer, and I just think we ought to be very, very careful before we create any further risk to the taxpayer and especially one that is as—I mean, I am as strong as the Chairman is, and I know he is very supportive of loans to small business. Still, we both know that this is a very risky process, and I think that we have to insulate and protect the taxpayer as much as we can.

Ms. SHONTELL. I think that the secondary markets have actually done a lot to take risk away from the Government. If you were to think of housing before 1968, what you had were thrifts whose deposits were insured by the Government making all housing loans.

If you look at what has happened since the growth of the secondary mortgage market, you have private sector capital at risk, you have mortgage bankers originating and servicing loans who are not Government-guaranteed entities, and you have the GSE's, who, again, are not Government-guaranteed entities, greasing the wheels of that machine.

The market has grown substantially, but it has not necessarily grown riskier in terms of the Government. The private sector——

Chairman LAFALCE. Something you said. You said the GSE's are not governmentally guaranteed entities. I want to underscore that point. There is specific language that says there is no Governmental guarantee.

Ms. SHONTELL. Correct.

Chairman LAFALCE. They are Government sponsored, but there is no governmental guarantee.

Mrs. MEYERS. But what would happen to our credit system if there were some kind of a failure, and we did not support it?

Chairman LAFALCE. The stockholders.

Ms. SHONTELL. Right.

Chairman LAFALCE. The shareholders of Fannie Mae, which is publicly traded; the shareholders of Freddie Mac, which is publicly traded. That is why they invest. Of course, they have been going up rather than down.

Ms. SHONTELL. Between Freddie Mac and Fannie Mae, there is over $12 billion of private capital that has now come into that market.

Mrs. MEYERS. Do you want to comment on that, Mr. Jungman?

Mr. JUNGMAN. No; thank you.

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Chairman LaFalce. I do want to comment on something Mr. Jungman said. You were pointing out some of the things that had to be done with respect to the RTC's portfolio. But, of course, that is a portfolio you didn't pick at all. That is a portfolio that, boom, it was plopped on your desk, and you said when it was plopped on your desk, "My God, that is the last portfolio in the world I would have had plopped on my desk."

That is not the case with a perspective Velda Sue or with Farmer Mac or the other GSE's. They say, here is the type of portfolio we want, and this is the only type of portfolio we are going to take. There are tremendous lessons to be learned from all of you, but one of the lessons is from the differences that exist.

Another issue is the matter of diversity. One of the problems with financial institutions, and there are many of them, is they are so specialized. They had no diversity, either geographically or with respect to product. So, many banks only existed within one State, and, in that State, they only made energy loans, or they existed in another State, and, in that State, they only made agricultural loans. They did not have either geographic or product diversity, and, therefore, if their particular market went bad, they collapsed.

This was true with the vast preponderance of our failed institutions. One of the beauties of the GSE's is we bring about this product and geographic diversity. So, when Ms. Shontell, Mr. Gibbons, and Mr. Edelman are determining what is going to be pooled, they will say, "Well, we want something from the Northeast, something from the Southwest, something from the Northwest; we want a little energy, we want a little bit of agricultural," et cetera.

I believe this is a fairly accurate representation of what you do—correct me if I am wrong—but you do try to bring about this diversity that, since the individual banks that don't diversify are able to sell off, they lose their exposure, we help these banks, and we help all these businesses across the country.

Please correct me if I have been in error or further expand upon my remarks if you concur.

Ms. Shontell. In terms of our geographic diversity, of the loans we guarantee in the portfolio, we are only residential mortgages, so we are not diversified in that regard.

Chairman LaFalce. Yes.

Mr. Gibbons. I certainly agree, and I think you have made most of the important points, but I want to underline that as GSE's we have the same concern that the Congresswoman does. While we are not Government guaranteed, our lives would be very unpleasant if any GSE failed. We think it is extremely important that while people recognize the contribution of GSE's, they recognize it is contribution that comes with a cost.

Among other things, we feel very strongly that GSE's should be adequately capitalized with a very tough capital requirement that regards the particular risk of their particular line of business and protects the American taxpayer. That is in our interest as a GSE in the market with other GSE's.

But a couple of other things I would point out is the amount of capital you need, and so forth, for the protection of the taxpayer is in part related to the frequency and thoroughness of examination.

Certainly one of the problems with banks and thrifts was that infrequency and perhaps low character of the examination.

Chairman LaFalce. That was the big problem. That was almost the entirety of the problem. Everything else is almost insignificant and unworthy of mention; that is it right there.

Mr. Gibbons. Right, and with the GSE's you do get to have some highly sophisticated concentrated examination. So, that is something important. But as important as regulatory examination, we think, is the consistent discipline of the market, because presumably this GSE would have to face not only a debt market but an equity market as well.

It is hard to imagine its getting itself into a lot of trouble if the equity markets didn't believe that it could do business well. I think the judgment of the equity markets is as important as the judgment of a regulator in keeping a GSE extremely focused on doing its business in a way that is relatively low risk. Those risks remain, and we don't ignore them. We spend much time worrying about them.

Chairman LaFalce. What is an adequate capitalization?

Mr. Gibbons. That would require significant study of the risk of the particular kind of lending that was being done. I could not imagine it would be less than the Basel Accords with respect to capital requirements.

Chairman LaFalce. Has anybody looked at the capital requirements in H.R. 660 and made any judgment on the adequacy of what we provide?

Mr. Edelman. Mr. Chairman, I think there are answers to two questions here. First, these GSE's are a form of insurance. People are effectively paying premiums and getting something back.

Insurance is a method of risk reallocation, and I think that if you look at the GSE's, whether it is Fannie Mae, Freddie Mac, or Farmer Mac, people are paying fees in order to get risk reallocation. You pay insurance now on your automobile so that if you have a collision, you are going to get paid back out of a fund you have been paying a small amount into on a regular basis rather than having to go out and pay for an enormous sideswipe in the parking lot one dark night.

One way to look at the question the chairman was asking about adequacy of capital is the typical ratio of borrowed money to equity in the financial institutions in this country. As a rule of thumb, people are looking for approximately 10 percent equity and 90 percent debt on the theory that a financial institution that has at least 10 percent equity will always be able to pay its debts. So, financial institutions are viewed by the rating agencies with a certain amount of——

Chairman LaFalce. That would be quadruple A, wouldn't it?

Mr. Edelman. Yes; but in order to get a triple A or even a double A or single A rating, the financial institutions are very conscious of this sort of rule of thumb. They don't want to get a lot above 10 to 1 debt to equity.

If you think of the institution and then of the individual loans as being modeled after that, 10 percent equity as a rule of thumb probably takes care of all eventualities of loss that people expect in diversified portfolios in the financial sector.

I think that if you look at Velda Sue, you are providing the same type of safety through the limit on the guarantee and the requirement for private sector exposure there. This is consistent with the basic rule of thumb in the financial community.

Chairman LaFalce. Something else which we do which is not done by Farmer Mac, although they have another way of dealing with it, is we require the originator to retain 20 percent of the loan. You could play with that. There are different approaches, but that was done for a number of reasons, too; to minimize, but primarily to ensure that the originator adopted credit standards that were creditworthy standards.

Mr. Edelman. You may want to compare the performance of the Farmers Home Administration direct loan program and the guaranteed loan program. The guaranteed loan program is similar to Velda Sue in that the private sector lender retains at least a 10-percent participation in the loan. The performance of those loans has been markedly better than the performance of loans that were direct loans by the Farmers Home Administration, albeit to a significantly different quality of credit.

But there is a factor in there involving active participation by the lender in servicing the loans and the private sector economic motivation, that made a considerable difference in performance of those loans.

Chairman LaFalce. That is one of the reasons that the Small Business Committee has gone away from direct loans. In fact, we have almost eliminated them in toto. Through guarantee and also within the SBA guarantee program, you can sell off as much as 90 percent of the loan, and under Velda Sue, even though there is no guarantee, we still would only permit the sell-off of 80 percent.

So, I think we have a very, very cautious approach that we have taken. That is not to say we could not make a lot of improvements. I can think of a lot already that should be made.

Let me go into some other questioning, and this is going to be touchy, but there is a lot of aversion to GSE's. I mean, whether justified or not, it exists. One possible way of dealing with this is saying, well, look, we need to create harmonization in standardization in an area where your risks are greater, small businesses more than in residential mortgages and, therefore, we need a jump start through a GSE. But once the market is made, once the standards are articulated, then the private sector could do it.

So, perhaps, we can create a mechanism that can self-destruct; that can be spun out of existence. I know you might not like this, because you already are in existence, and I think that unless you started out that way it would be extremely difficult to do. We would not want to do that. We are only talking about doing that. But is there a way when you start an organization to start it in a way that says, look, we give you a mission in life, make a market, establish the criteria, the standards, get followers from the private sector who then can do it so that you can be spun out of existence once these criteria are met?

Anybody want to comment on that? Or was I showing my lack of wisdom in even asking the question to this forum?

Mr. Edelman. Are you not really spinning things out of the Government as they grow? That is, Fannie Mae and Freddie Mac, as

they point out, have billions of dollars of private sector investment in them because they have succeeded. That equity investment wouldn't be there otherwise.

I think that really you have already done it with them; you just have not done it in name, and we like to think Farmer Mac is headed in that direction and was set up that way. Velda Sue could be that way, too. If it became successful, there would be a major private sector equity investment.

Chairman LaFalce. Let me ask this question. Is Fannie Mae still to be considered a GSE since you are now owned by the public?

Ms. Shontell. I think the GSE describes a very special kind of franchise the Government has given us. We have certain privileges that go to how we borrow in the capital markets primarily.

Before that, we have a very special and limited mission, and that is to make a market in certain kinds of loans, residential mortgage loans for low-, moderate-, and middle-income Americans.

So, it is a very special franchise that is a Government franchise. From that perspective, I think we are a GSE. We are not a purely public institution. But we are purely publicly funded.

When we were privatized in 1968, we were funded with Government money. There was $125 million of the Government's capital put into Fannie Mae. That capital has since been repaid, and now we have $8 billion of stockholder capital.

So, I think there has been a tremendous movement toward privatization. But the franchise that the Government has given to us, the Government has given important franchises to a lot of different kinds of companies and a lot of different industries. We and Freddie Mac have to be a very specialized, which is why you see a lot of attention paid to us.

Chairman LaFalce. Any other comments?

Mr. Gibbons. The only thing I would point out is that any kind of sunsetting of that sort might work against your desire to get fixed-rate, long-term money into the appropriate small businesses. We are in the market every day selling mortgages with 30-year maturities, which means that people making credit judgments about us are looking 30 years out, and if we are providing long-term funds, 10 or 11 years, to small businesses, some which might be appropriate with regard to certain purchases of equipment they may need, it is going to be very difficult to accommodate long-term borrowers with any kind of sunsetting provision.

Chairman LaFalce. Why would smaller banks view GSE's in this area with a certain amount of concern? Why wouldn't they be embracing it enthusiastically? Fear of competition? Fear of reduction of their spreads? To what extent are their concerns founded? To what extent are their concerns paranoia? Any comments?

Mr. Edelman. We have certainly seen a little bit of that with Farmer Mac. It is a culture shift for them. People who are accustomed to being portfolio lenders have to readjust to think in terms of mortgage banking income, fee income, rather than risk income. That is, they must think in terms of making money through origination and servicing of loans rather than through the spread in their portfolio. They must think in terms of making long-term, fixed-rate loans to their borrowers rather than short-term loans

that are an easier utilization of deposit funding. These are all changes in culture for smaller institutions.

In the agricultural sector, it has been particularly difficult because many of them are located in areas where there is not very much Fannie Mae or Freddie Mac lending going on. Therefore, securitization of loans is new and different for them, while some of the smaller institutions in metropolitan areas will still be familiar with Fannie Mae and Freddie Mac to a greater extent.

So, in our case at Farmer Mac, it is an ongoing educational process, and I think Velda Sue is going to be something similar.

Mr. GIBBONS. If I could just make one comment, I think I would have a lot of sympathy for the smaller bankers, and I am not sure whether it would be a concern with narrowing spreads or the competition or what it might be. But our financial system has undergone a revolution and securitization is certainly a part of that revolution. This proposal would extend that a step further.

I think that revolution leaves traditional depositories really in quite an uncomfortable situation, where there is an effort, one asset type at a time, to strip out those assets whose risks can be controlled and sold into the secondary market out of the depository sector.

You see that with mortgages, with credit card loans, auto loans, and with much of equipment leases. You also see a tendency to finance companies, commercial finance companies, to grow up with regard to assets they know well. So, for instance, it is now specialized finance companies that finance Xerox machines, telephone equipment, and so forth.

What does that leave the banks with? Doesn't that leave the banks with credits nobody yet understands? There is lending that doesn't lend itself to the secondary market that continues to be made. But I think it is a difficult position to be a depository, especially a small depository now, and to have any confidence in what is left, what kind of lending continues to be made as this revolution, securitization, sweeps through the financial markets.

Chairman LAFALCE. Any other comments?

I want to thank you all. What I would like to do is submit additional questions to you in writing and ask for you to respond to them, and then what I would like to do is get together with you in an informal setting where we can discuss things.

We are proceeding on this. I would like to bring the administration on board. I know the administration is seriously considering this. I have talked with countless individuals. They realize there are a number of different approaches.

I personally don't think we can have a very successful program unless we have a GSE. I think we will make minimal strides forward if we just try to change existing laws to facilitate the development of the private sector alone. I think the GSE is going to be necessary, and we could save ourselves at least 5 to 10 years that way. It will develop so much faster, with virtually no downside risk, less risk than the present course we are taking, closing financial institutions or giving additional SBA guarantee authority.

I also think, too, because Fannie Mae and Freddie Mac are publicly traded corporations dealing exclusively with real estate, Farmer Mac is not publicly traded.

Mr. EDELMAN. Yes; it is.

Chairman LAFALCE. Your concentration has been with the agricultural sector, correct? That is why it is called Farmer Mac?

Mr. EDELMAN. Yes; it is, although the rural housing component of Farmer Mac goes far beyond the agriculture sector.

Chairman LAFALCE. The housing, of course. But insofar as your commercial, that has been exclusively agriculture; is that correct?

Mr. EDELMAN. Yes; it is.

Chairman LAFALCE. I really think that we need a new GSE for a whole slew of reasons rather than considering any change in any of your charters, which would diffuse your energies and cloud your mission.

Do you have a general tendency to agree with that, Ms. Shontell?

Ms. SHONTELL. We view that we have been very successful because we have been very focused on housing. We also view that the capital that we have grown is housing's capital, and that is our mission.

Chairman LAFALCE. Mr. Gibbons.

Mr. GIBBONS. We agree.

Chairman LAFALCE. Mr. Edelman.

Mr. EDELMAN. I think that the whole notion of Farmer Mac is slightly different, and the notion of commercial securitization is such that, perhaps, the integration of these commercial securitization efforts might make sense.

So, I don't know that I would entirely agree. Maybe agriculture should not stand alone. Perhaps it is a kind of commercial loan that could be integrated with others.

Chairman LAFALCE. You are just getting into business loans, right? As of November of last year?

Mr. EDELMAN. No; actually we had done them in December 1991.

Chairman LAFALCE. December 1991. All right.

Mr. EDELMAN. You are asking me personally? I had been financial adviser to the SBA in 1986 and 1987.

Chairman LAFALCE. No; not you personally.

I thank you very much.

The committee will stand adjourned.

[Whereupon, at 11 a.m., the committee was adjourned, subject to the call of the Chair.]

ROUND TABLE ON CREDIT CRUNCH

WEDNESDAY, MAY 12, 1993

House of Representatives,
Committee on Small Business,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m., in room 2359-A, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the committee), presiding.

Chairman LaFalce. The Small Business Committee will come to order. Good morning.

Today's round table is part of a continuing inquiry that our committee has been conducting into the credit crunch affecting small business.

On March 10, when President Clinton announced his proposal to revise banking regulations to increase small business lending, a significant chunk was taken out of the credit crunch wall. But much of that wall remains.

Without access to credit, small businesses often stagnate. When they do, good businesses suffer unjustified reversal, jobs disappear, and our economy as a whole suffers.

Congress determined, 40 years ago, that part of the solution could be provided through financing under a program to be operated by the Small Business Administration. Initially, this program consisted of direct or Government-made loans. But over the years, it evolved into a program under which SBA guaranteed loans made by private lending institutions.

The credit demand today, however, is so enormous that the program has already used its entire allocation for the year and has closed until the first of October when we commence a new fiscal year. This, of course, is intolerable, and we are working to ensure that SBA's 7(a) Program is included in the supplemental appropriation bill which, hopefully, will be passed and signed into law very soon.

But it is also time to take Federal financing to a new plateau. I personally think that we should take advantage of a system which has been utilized effectively in other sectors of our economy, such as the housing sector, for decades—the development of a Government-sponsored enterprise [GSE], but this time focused on small business financing.

I propose the establishment of such an entity, which I call the Venture Enhancement and Loan Development Administration for Smaller Under-Utilized Enterprises, otherwise known as Velda Sue.

This GSE would link small businesses to the long-term funds of institutional investors. I believe that such a GSE would help solve some of the problems that we will be hearing about today.

This is Small Business Week. Small business owners and operators are convening here in Washington to celebrate this event. A number of them have agreed to be with us this morning, and to relate their personal experiences. I am extremely pleased that they have done so.

Our purpose in today's discussion is to secure first-hand information on the financing needs of small firms and the results of their failure to obtain this financing.

But before we begin, I would also note that we now have a new Administrator of the SBA, Erskine Bowles. I have met with him prior to his confirmation. I was pleased to learn that he does indeed understand the importance of increasing the availability of finance in the small business sector. I look forward to working with him and with you in the months to come. I am pleased to have you before us today.

[Chairman LaFalce's statement may be found in the appendix.]

Chairman LaFalce. Do any Members have any opening remarks that they wish to make?

Mr. Knollenberg. Mr. Chairman, a very, very brief one. I just wanted to acknowledge the fact that from my home district that we have Linda Tolicoeur, who, in fact, is from Oakland County, which is the county of prominence in my district. She chaired the legislative committee of the Oakland County Chamber of Commerce. She is also the Michigan president of the National Association of Women Business Owners. So, Linda, take a bow, in the front row.

Thank you, Mr. Chairman.

Chairman LaFalce. Thank you.

We will proceed. Ladies and gentlemen, we have a great many of you. Of necessity, we must limit you. Therefore, I am going to ask you to try to keep your remarks, if you can, to 3 minutes. If not to 3 minutes, to no more than 5, absolutely.

Also, I have a personal problem. I will not be able to chair the entirety of the hearing. The President has asked me to come over to the White House for a ceremony this morning, and he has asked me to be there by 10:45 for an 11:00 ceremony. So, another Member will have to continue for me. I will have to leave at about 10:25.

Let us begin. Mr. Farrell.

TESTIMONY OF TOM FARRELL, ADS, INC. AND GIFT SHOP INTERNATIONAL, PITTSBURGH, PA

Mr. Farrell. My name is Tom Farrell from Pittsburgh, Pennsylvania. I own Ads, Inc. and Gift Shop International. I would like to thank you for having me.

Small business lending is very important to me strictly because, as a growing business, I cannot get the financing to have the growth that I need. When you get into the service business, like I am, it is hard to get financing. I find that when we knock on doors to secure financing, that asset-based companies, buildings, and

equipment, that it is much easier to secure money for that reason. Whereas I need money to grow for inventory and for cash-flows.

I think that it is good that there is going to be institutional-backed money out there. But I think that there should be some Federal money for personal lines of credit, and secured maybe by receivables or something like that.

It is too tough when my suppliers are demanding payment. People who are my customers pay slow. There is an evolution of the credit crunch, and it hurts everyone and all those who I deal with.

I also feel that there should be a better focus on companies that have a track record, and have over 20 employees, and could really use the money. They are ready to grow, and they are ready to burst. They cannot secure the financing. A lot of financing seems to go to start ups, since all start ups do need the money to take off and get going. But there are a lot of good companies out there, small companies, that have a track record, and could really use the help of the Federal Government to secure this money.

Thank you.

Chairman LaFalce. Mr. Cohen.

TESTIMONY OF RONALD COHEN, COHEN & CO., CLEVELAND, OH

Mr. Cohen. Thank you, Mr. Chairman, for holding these hearings and for allowing me to be present.

My name is Ronald Cohen. I am senior partner of a regional CPA firm headquartered in Cleveland, Ohio. We service exclusively small business entities. I primarily act as an adviser to those companies in obtaining loans.

As a general statement, I would like to say that in my 36 years of practice, I have never ever come close to having the problems getting loans for my clients as I am experiencing now. I could talk for an endless time on many of the reasons, the causes, the attitudes of the banks, the disappearance of small banks, et cetera.

The Velda Sue instruments definitely will be a help. But I do want to make a brief comment on one specific area that I do not believe has gotten sufficient attention. Bankers have told me that the reason that they are not making loans to a certain categories of our clients is because upon making a loan, that it will immediately become classified, and become one of their problem loans.

The type of client that I am talking about are the old, established, well-run, historically profitable businesses that have had 2 years of losses. These become problem loans regardless of the collateral, regardless of the character of the borrower, and regardless of the plan for turn-arounds or whatever.

In my practice alone, I would estimate that there were 500 jobs lost as a result of companies having to contract because of the restriction on credit provided by the banks. The bankers have told me that if the regulators would allow them to make loans to good companies, well collateralized loans, in spite of the fact that they have had recent losses and have no guarantee that there would be a future profit, that part of this credit restriction would be opened up.

Thank you, sir.

Chairman LaFalce. Thank you very much, Mr. Cohen.

Ms. Margaret Lescrenier. I am not sure how to pronounce that.

Ms. Lescrenier. Mr. Chairman, you have an ability in French that belies your last name.

TESTIMONY OF MARGARET LESCRENIER, GAMMEX RMI, MIDDLETON WI

Ms. Lescrenier. Thank you very much, Mr. Chairman, and members of the committee. I am Peggy Lescrenier. I come from Middleton, Wisconsin. I want to thank you again.

My major point is that I want the committee to understand that it is necessary to relieve the pressure of the heavy-handed regulatory dictates that are imposed on local banks. I wish to exemplify that with a brief story.

There is a small established business that makes computer program peripherals, a very specialty product for a niche market. It is working in the global marketplace, buying products from abroad and selling it abroad. It had borrowed money for expansion.

The credit line involved the usual, which was guarantees, personal guarantees, collateral, and something called a loan covenant or a formula. This formula meant that the line of credit had to equal 75 percent of the accounts receivable, and 40 percent of the inventory. Common in small business, a large shipment did not ship when it was supposed to. It slipped a week. In that slipping of a week, the accounts receivable slipped into the next month.

In the bank's eye, the loan was out of covenant. The bank had one solution. You must pay back on the loan. The company said absolutely not. We need that money to pay for a letter of credit for the materials that we need to make our next month's shipments. The shipment went. We are going to have a sufficient amount of money.

The bank said absolutely not. This is the regulation, and this is what you must do. The result was very simple. The company had to pay back money on the loan. It could not jeopardize its letter of credit. So, it was simple. It simply cut its payroll in half for that month. But what it meant is that the personnel worked for 4 weeks, but were only paid for two.

Now the result is that company, instead of being dynamic and energetic, has had a tremendous loss of morale. The key people, two of them, have already left.

I am asking is this heavy-handed regulatory effort really necessary, because the local banks no longer have the flexibility that it needed in knowing that this company was good for its loan, and could continue business, and sell not only domestically but internationally?

I hope that you remember that in formulating any public policy on your loan availability.

Chairman LaFalce. Thank you very much.

Dr. Chester McKee.

TESTIMONY OF CHESTER MCKEE, PRESIDENT, IN-SITU, INC., LARAMIE, WY

Dr. McKee. I am with In-Situ, Inc. in Laramie, Wyoming. We are an environmental company. We manufacture our instrumentation there. The instrumentation is used on hazardous waste sites to monitor ground water and surface water, and to monitor underground storage tanks.

We sell to Fortune 500 companies, such as Dupont and Exxon, and overseas as well. Recent sales have been to the Taiwan Water Board, British Petroleum in Singapore, the DeBeers Consolidated Mines in Botswana, BHP in Australia, and, of course, throughout the United States and other parts of the world.

Sales this fiscal year are anticipated to be over $7 million. We employ 70 people. At this time, about 2 years ago when we went to look for a loan, we had a half a million dollars in the bank.

Another part of my background is I was a university professor and went into business. I did not think too much of business people when I first started, but I have come to appreciate and respect the responsibility that we bear and the challenges over which we must prevail to succeed, most of them put there by our Government.

Our growth averaged about 30 percent a year. We knew that we would need more capital to grow. We decided to prepare by borrowing $200,000. Now we just could not borrow $200,000. We had to secure that loan with cash. So, we borrowed it, and put up cash to borrow.

We paid down the loan in 6 months. We have $4 million in fixed assets. We are a solid company. We went to our banker to borrow in the range of $500,000 to $800,000. We shook on the deal. The local banker gave me his word that they would do the loan. Later they said, after a SBA guarantee of 80 percent of the loan, that they would not do the deal.

Chairman LaFalce. You were seeking $200,000?

Dr. McKee. We were seeking—we had borrowed $200,000 before—we were seeking now a larger amount, between $500,000 and $800,000. We settled on trying to go for $800,000 eventually. We had an 80-percent SBA guarantee on the loan.

Chairman LaFalce. What was your collateral on this?

Dr. McKee. We had our assets that we put up, which were much larger than the loan.

Chairman LaFalce. You said $4 million in fixed assets.

Dr. McKee. We have $4 million in fixed assets. I can show you that with an audited balance sheet. There are buildings, a half a million in cash, and equipment. We had 40 acres of land. That land was next to a golf course and next to a hospital. It was good quality land.

Chairman LaFalce. Any liens on it?

Dr. McKee. No liens.

Chairman LaFalce. Any prior encumbrances?

Dr. McKee. Our debt to equity is like 5 percent.

Chairman LaFalce. What did the bank say?

Dr. McKee. Pardon?

Chairman LaFalce. What did the bank say?

Dr. McKEE. Well, the bank initially said that they would do the loan. Later they did not.

Chairman LAFALCE. Why, what was the reason?

Dr. McKEE. We really did not get a good reason for it. We felt that the decision was not made locally—that it was made either in Cheyenne or back East where the parent company was. We never got a really good definitive reason for it.

Mr. COLLINS. How much of that half million cash were you going to use?

Dr. McKEE. Well, we have been using cash to expand. The half a million dollars for us we considered a reserve account. It is a little over 1 month's bills for us in terms of operating, and managing, and investing in R&D.

Chairman LAFALCE. Did you ever get it from a different bank?

Dr. McKEE. Eventually, they said that they would do the loan. We became concerned, like these other gentlemen here, that if we ran into a tight spot, 15 years of what we have worked for just might be called out on a loan. We might have $4 million in assets go off on a fire sale just to pay off a relatively small loan in comparison.

We went to venture capital people. We were a little too big for the venture capital people. We went to Smith Barney and Alex Brown for going public. They said come back when you have $20 million in sales. So, we are kind of in a gap. We have gone down to, from 30 percent annual growth, we have gone down to 5 percent, just financing it out of cash-flow. So, we could have created more jobs.

My son ran into my competitor in a trade show in Cologne, Germany. He said that he had $4 million, and he said that he was going to bury us.

Thank you.

Mr. COLLINS. I think that Khrushchev said that, too.

Dr. McKee. Right.

[Dr. McKee's statement, with attachment, may be found in the appendix.]

Chairman LAFALCE. Mr. John Fedor from Cleveland, Ohio.

TESTIMONY OF JOHN FEDOR, PRESIDENT, MASCO MACHINE, INC., CLEVELAND, OH

Mr. FEDOR. Yes; thank you, Mr. Chairman, and members of the committee.

My company is a machine tool builder in Cleveland, Ohio. We manufacture large and sophisticated machinery that requires a great deal of working capital. Our company has been in business for the past 31 years, creating all types of machinery, from making light bulbs to making rocket boosters for satellite launchers. We also manufacture military equipment, ordinance and so forth.

So, our problem is that we have had difficulty with working capital of late. Our company has been in business for 31 years. In 1989, we embarked on a major expansion program. New products were introduced. The plant was expanded. Additional personnel were hired. Products were converted to the metric system to make them world class. Our business systems were improved to keep up

with all of this action. In short, we are doing the things that all companies must do to remain competitive in a global marketplace.

The bank that we had been doing business with for 15 years set up a revolving line of credit with us for over $5 million and granted us a long-term loan, over $1.25 million, to finance equipment purchases and plant expansion.

A year into our expansion program, while we were enjoying the best sales in our company's history, our bank was in great turmoil. The vice president handling our account changed five times within an 18-month period. The bank panicked and cut our revolving line of credit by two-thirds, and then subsequently cut that amount in half. Our working capital loans were eventually completely eliminated. The only loans that we had available were tied to 85 percent of our domestic accounts receivable.

Eventually, in the midst of our expansion, we were told to seek another financial institution. This was not an easy task when we had millions of dollars' worth of projects on our floor and no working capital to complete these projects.

The lack of working capital backed up our whole system, causing late deliveries, inefficiencies, severe penalties, and great loss. Our company was almost forced out of business as a result of this upheaval.

Today, I am happy to report that most of our problems are behind us. However, we have had to cut back our operations. We are still in the process of trying to restore our credit with our suppliers, who were forced to extend credit with us during this time period. In other words, our creditors and suppliers had to become our bank.

We got through this crisis by the skin of our teeth, only because our company was very strong from the start. Other small companies that have been through similar deals have not been as fortunate as us. Some have had no other alternative but to declare bankruptcy.

In fact, in my efforts to find another financial institution, a bank representative suggested that I file for chapter 11 bankruptcy protection. I promptly removed him from my office.

Stories like mine are repeated all over America. In the United States, if small business manufacturers are to continue to develop and produce state-of-the-art products that can compete worldwide, they must have access to working capital that makes it possible without the threat of what happened to our company hanging upon them.

A loan guarantee program would help by facilitating a secondary market for loans that would finance the purchase of capital equipment for our customers, and most importantly provide working capital necessary to sustain and strengthen this Nation's manufacturing sector.

In my case, and in the case of many manufacturers that are capital intensive, I would like to emphasize that we must find some way to finance the work in process. In the case of large equipment manufacturers, the work in process is what becomes the asset. Bankers just do not lend on that type of collateral anymore. It is a big problem.

I thank you.

Chairman LaFalce. Thank you, Mr. Fedor.

Mr. Collins. Mr. Chairman, I relate to this man's story. I really do relate to that situation. I do agree that we do need some assistance in financing in those areas, and coming from the private sector rather than Government programs. But let me ask you one question about the bank itself. You said that it was in turmoil.

What caused the bank's turmoil?

Mr. Fedor. I think that a lot of it was that they were raising capital, and they were in the process of changing their strategy. I think that they were out looking to purchase new banks. I believe that they just stopped lending to small business. Their emphasis is on home equity and mortgage loans, and buying credit card companies. I think that it is just a terrible thing, what happened in our banking communities.

Chairman LaFalce. If I may interject a point. There have been many changes within the field of banking. I do not think that they have been very helpful to the small business community. I wish that we had more members from the Banking Committee in attendance this morning. We have about a dozen of our 40-some members who are also on the Banking Committee. But most often, the full Banking Committee does not hear the perspective of the small business community.

So, legislation has been passed that I do not think has been adequately sensitive to the concerns of the small business community. For example, in 1989, a law called FIRREA was passed, ostensibly to deal with the problems for S&L's. In fact, in my judgment, I think that it multiplied the problems of our thrift industry and our commercial banking industry at least ten-fold if not more. It took what, in my judgment, was basically a regional problem, and converted it into a national crisis.

But it also focused the attention of all banks almost exclusively on one thing, and that is capital. Capital is extremely important. There are many other things that are important though, too. Management is important. Cash-flow, profitability, et cetera. It mandated that our financial institutions go to very sold capital ratios that all would say they should be at, but that they get there precipitously, quickly, immediately. Almost saying, if you are sick, you must get fully well immediately or you must die.

As a result, so many financial institutions in this zeal or this mandate to improve their capital ratios did a number of things. First, in my judgment, they sold off their best assets to improve their capital position. Second, they stopped making loans. Because whenever they would make a loan, they would be impairing their capital ratios, particularly if it was a business loan. Because at the same time that this phenomena was taking place, we were adopting not just new capital ratios, but risk-based capital.

So, we had different requirements for different types of loans. A home loan was deemed to be much less risky than a business loan. So, you require much higher capital if you make a business loan than you do a home loan. If you put your money into Government securities, that is deemed to be risk free. If you have a SBA guarantee, it is deemed to be risk free. So, you do not need capital for this.

A number of phenomena are working at the same time. They are not making new loans. Then with the existing loans, what they are attempting to do is put the squeeze on you. So, you had a $2-million line of credit, and they bring it down to $1.5 million, and then $1 million, and then to $500,000.

Then they tell you, although you have been in business for 20 years with a line of credit, that you really do not need a line of credit to be in business. You look at them rather dumbfounded. You say that somebody does not understand the world of business. I need this line of credit.

Then they say yes; you need the line of credit, and you have been deemed to have had adequate collateral in the past, but now we really need more collateral. We need twice the amount of capital that you historically have had to have, or triple it. Or the amount of capital that you have had is adequate, except that we have reappraised the value of your collateral, and it is now less than what it was erroneously appraised to be for the past 20 years. Therefore, you still must double it.

We will improve our capital ratios by putting our money not into business loans, but into Government securities. We will make a lot of money that way, because we have a great interest spread.

So, the banks are safer and making more money. The problem is the economy is dying; the small business community in particular is dying. This is the message that I have been trying to get across to the Banking Committee with great, great difficulty.

If you would excuse me, Mr. Collins, but when you asked what is going on, I just had to take this opportunity to share my perspective with you.

Mr. Collins. I would like to expand on that just a little bit there.

Chairman LaFalce. If you agree with me, go ahead.

Mr. Collins. You knew I would. It goes back to what I was speaking of earlier. I would like to see reform coming to the private sector. I would like to see changes in banking attitudes coming from the private sector, and more funding available from that area without any more Government participation. Because I said, as the chairman just said, that Government regulation has a lot to do with the reason that financing kind of dried up in the marketplace.

But I want to go back further. I want to go back to 1986 when we had the changes in tax codes that also went against business. It changed investment tax credits. It changed capital gains. It passed some laws. It put in place the alternative minimum tax and those such things.

That led to the downfall, or to part of the downfall, of S&L's. People got called out on a limb, and wound up in serious trouble. The S&L downfall led to the 1989 regulation changes in the requirement for capital by banks.

Again, you had a downturn in business following all of that as an effect from the 1986 change. Then we had the 1990 tax increase, which again fueled the recession. As the chairman says, we have an economy now that is stagnant. But yet, we are sitting here today looking at billions of dollars proposed for further tax increases, more Government intervention, more Government participation. I think that it is going to lead to even further recession.

With that, Mr. Chairman, we can move on.

Mr. Fedor. Mr. Chairman, I would like to just make one more comment. I was dealing with this bank for 15 years, and, 6 months before they almost ran me out of business, they nominated me for the Entrepreneur of the Year Award.

Mr. Chairman, do you see this chart?

Chairman LaFalce. Yes.

Mr. Fedor. This followed what happened in my business.

Chairman LaFalce. I appreciate that. If you would submit it to us after the hearing, I would appreciate that more.

[The charts may be found in the appendix.]

Chairman LaFalce. In the audience, do we have Ms. Mary Walter or Ms. Carol Horning?

[No response.]

Chairman LaFalce. We will now hear from Mr. John C. Rennie of Massachusetts.

TESTIMONY OF JOHN C. RENNIE, PACER SYSTEMS, INC., BILLERICA, MA

Mr. Rennie. Thank you, Mr. Chairman.

In previous hearings, especially most recently in the Senate Banking Committee subcommittee hearing on this same topic, I mentioned a point that I would just like to make here. It becomes evident, as you hear the different people testify, that financing for small business, because of the diversity of the small business community, has to be looked at as sort of a mosaic, rather than any kind of single solution.

Therefore, when we are talking about 7(a) loans, Velda Sue, banking, and so forth, they are all important. It is not that we will do one thing and that will solve the small business financing. I think that is very important. Sometimes people feel that if they solve one problem, they will be off the hook. That is not the case.

My particular situation is kind of symptomatic. I am kind of at the top end of the small business ladder, you might say, in terms of size. But if I have these kinds of problems, you can imagine the difficulties of much smaller and less-established companies.

My company is 25 years old. It was started by two high school classmates and myself. It is an engineering and manufacturing company supplying the Government, big aerospace companies, and international companies. It has sales of about $30 million.

We have been profitable for all but 4 years. We have about $10 million in assets, and $8 million liquid assets, mostly in receivables. Since 1986, we had an unsecured line of credit, a $1 million line of credit, which we never used. We also had been dealing with this bank, one of the largest banks in New England, for 13 years. We are the kind of people who bring the bank in, or we go to the bank three times a year, and brief them on the business.

They get statements that they can count on every month. We are publicly traded in London. We have had a big six auditor since day one. In other words, we are a substantial company, and we are well known in the community. So, the character loan aspect of things is present if there are any character loans present.

So, we're going along fine. In the 5 years prior to the time that I am going to mention, January 1992, we averaged having something

like $1.5 to $2 million in cash in the bank. In other words, we always had cash in the bank. So, we had not used the credit line, but we had been paying for it each year.

In January 1992, an event happened that triggered our problem. That was that the Government, the U.S. Government, lost $2 million worth of our invoices in the movement of one of their payment centers from Boston to Columbus, Ohio. More than a month's worth of invoices were lost. Of course, you do not know this until the checks do not show up.

So, in early January, there were no checks. We had an immediate need to dip into our credit line for a short time. We notified the bank immediately that we would need a temporary draw-down. We estimated, my CFO estimated, on the order of about $500,000 for 6 weeks. Then we would get it sorted out, and we would be back on a normal cash-plus kind of situation.

The bank immediately canceled the credit line that we had been paying for 5 years. They forced us to switch to a secured line. We were in trouble, because we had a payroll coming up. So, we were not in a good bargaining position. They forced us to switch to a secured line with all kinds of onerous terms, covenants, and so forth, which we knew that we could not keep. They knew that we could not keep, because some of them were so tight on where we were at that time.

It cost us, I think that at least one bill was $2,500 in legal costs just to sort out switching over from the unsecured to the secured line of credit. We ended up borrowing about $300,000 for 3 weeks. Then we moved back to more than $1 million in the bank. We have had more than $1 million in the bank every since.

During 1992, they indicated, the bank that we had been dealing with, that this secured credit line would not be reviewed until September 1992. We then began a search to see if we could obtain an improved credit line, and frankly changed banks. We felt that we had been pretty well abused by the bank that we had been dealing with for quite a long time.

In the end, we have not needed cash. Therefore, we could afford to look for some time. We were looking for a $2-million line of credit, not so much for working capital, but more for standby letters of credit on international work, because our international work is increasing pretty dramatically.

We were turned down by four banks, four major banks in New England. We finally had offers in late 1992 from two banks, both of them primarily because they knew me in activities in the community.

However, one of them was for a secured line, and had quite onerous covenants involved with them. The other one was for an unsecured line, and we ended up just last week selecting that bank to go with.

I think that it is just symptomatic that here we were doing all of the things that you are supposed to do as a bank customer, and someone that they extend credit to, a solid company in every respect. But one event, which was easily understandable—Government receivables. They are just about as solid as you can get. It triggered an event where the bank reflected the difficulties that they were having in the 1991 and 1992 timeframe with the regula-

tions and the adjustments that they have had to make due to the types of factors that you mentioned.

Chairman LaFalce. I think that one of the problems is that individuals today, whether bank examiners or loan officers, are afraid to make a mistake.

Mr. Rennie. Right.

Chairman LaFalce. It is easy not to make a mistake. You never take a risk. But financial institutions must be in the business of risk management, not risk avoidance. You can become the president of a bank easily, if you just avoid risk. You will never make a mistake.

Examiners must understand, in reviewing portfolios and decisions, that they cannot use hindsight in determining whether or not particular loans should or should not have been made. If it goes wrong, that does not mean that an incorrect decision was made.

The pendulum on life on virtually everything ought to be dead center. In the mid-1960's, it went way, way too far to the left. Then in the late 1980's and early 1990's, it went much, much too far to the right.

What we have constantly been trying to do is bring it to center. When it went way left, we tried to bring it to center. When it went way right, we fought against that and tried to bring it to center.

Mr. Poshard. Mr. Chairman.

Chairman LaFalce. Yes, Mr. Poshard.

Mr. Poshard. Thank you.

Since this is an informal discussion, I just would like to make a comment here. I had discussions in my district with banks and with people similar to Mr. Rennie and some of the things that he has brought up. It is also possible, I think, and true in many instances that banks are using the excuse of the tightened regulations to deny people who have been in good standing, and who for no other reason should be considered not in good standing, adequate lending.

In your case, and in the case of many people who I investigated in my own district, there was no good reason for small businesses not to have an acceptable unsecured line of credit from some banks. When I queried those people as to why that line of credit was not extended when in the past there were no problems, that this was a perfectly good solid small business, they always came back to the excuse of the regulations, the regulations.

When I asked what is it in the regulations that prevents you from extending that line of credit, as you have done in the past, it was always too much paperwork, or some nebulous kind of thing out there.

I think it is true, in our overreaction to the S&L crisis or whatever, that we probably overregulated out of wanting to make sure that accountability is present in the banking profession, so that we can assure the taxpayers that their money is not going to be lost to the tune of another $250 billion or whatever.

But I do not think that there is a whole lot in the regulations that are preventing banks from lending to very solid businesses like yours. I think that is a very convenient excuse right now that a lot of banks are using.

Chairman LaFalce. I think that there is much to what Mr. Poshard says. As you said, I think that it is a mosaic. I think that there is truth to the fact that there are some laws that should not have been passed, and regulations that should not have been implemented. I also think that a good many financial institutions are using that as a scapegoat for their own internal change in strategies, for their own internal weaknesses, whatever it may be.

Mr. Rennie. For me to get upset with a bank is maybe fairly common. But my CFO, I have never seen him so upset with the bank. He really felt absolutely that we were the victim of some kind of either bank shift or some other thing that we could not figure out. We saw no reason whatsoever that even the regulations, as you said, Mr. Poshard, would justify this kind of a thing. It is what you have a credit line for, as far as we understood, a temporary need for money.

Chairman LaFalce. Some financial institutions might get their officers together and say look, guys, we have too much in construction loans right now, so, no more construction loans. To the extent that we can, let us whittle it down.

This is the game plan. So, the business that comes into the bank, while a good business, is going to have to be viewed not as it was viewed last week, but it is going to have to be viewed against the new game plan. So, the lender has to find a way to turn him down gently.

How does he find the way? Well, he can blame it on George, or something like that. But all of these things are at work. The problem is whatever the reason, the small business person is the victim. You are the victim.

Mr. Pinkerton.

TESTIMONY OF WILLIAM PINKERTON, PRESIDENT, PROJECT SERVICES INTERNATIONAL, INC., PITTSBURGH, PA

Mr. Pinkerton. My name is William Pinkerton, and I sincerely appreciate the opportunity to address the committee here today.

I am a small business owner in Western Pennsylvania, and I am one of those who has had a difficult time obtaining credit at a critical time in the building of my small business.

We are, by and large, a labor and knowledge asset-based company as opposed to a plant and equipment asset-based company. Our only financing is a line of credit based on receivables and backed by my personal assets.

I have a couple of cases I would like to go through very quickly with you, if you will bear with me.

Approximately 2 years ago, we perceived a need in the Corpus Christi area of Texas for a plant equipment refurbishment shop facility to repair valves and instrumentation in the many petrochemical refinery plants in the area. We had some cash from generated profits, but knew that it would take some time and considerable expense to establish ourselves in that area.

We approached our bank, with whom we had been doing business for approximately 8 years, and explained the situation to them. Our banker indicated an understanding of our situation, and, further, that the bank would back us, that is, provide funding in

the way of a loan, when and if necessary, if we needed more money.

Over the next several months we invested our own funds in the venture, and as we had surmised, we found that we would need additional funding to continue. As planned, we again approached our bank and asked for a loan aside from our line of credit, which, as stated, was backed by receivables and personal assets. To our amazement, we were turned down with the explanation that "money is tight right now." "We are just not making loans at this time." When pressed, our banking agent told us that regulations on banks had made it very difficult to make loans, especially to small businesses; and that money was "just not available." In fact, lending authority had moved up one step, and our agent did not even have the authority to lend any longer.

The end result of this unexpected stance taken by our banker was the closure of our facility in Corpus Christi, the layoff of the eight people we had hired to work at the facility, and the loss of our own investment of approximately $200,000. We have survived but the loss has since greatly hampered our ability to grow.

We recently approached another bank to attempt to obtain a SBA-backed financing to be used as working capital, both in the development and marketing of industrial interactive multimedia training programs, and an industrial maintenance management software program which we have already developed, again through utilization of our own generated profits.

Our request was presented to a joint meeting of bank lending officers and local SBA representatives in February of this year. Although the bank has indicated that they might be willing to loan money if my own personal assets, along with the personal assets of my two junior partners, were pledged, and are sufficient to cover the loan, neither the bank nor the SBA representative held out much hope that an SBA bank loan that we hear so much about would be made available. This loan request, by the way, was also accompanied by a well-done business plan.

Chairman LaFalce and members of the Committee on Small Business, I applaud your efforts in introducing the Velda Sue legislation. We, in small business, need above all things continuity and predictability in the availability of financing if we are to continue to be the engine of job creation as we have been in the past.

Velda Sue could be an important small business credit market underpinning. However, we need to go further. Under Velda Sue, for example, service-oriented businesses would not benefit despite being a leading contributor to the growth and development of what is shaping up to be a knowledge-based economy. Banks must be placed within a regulatory environment where small business financing is a key continuing component of their business. Making money by investing in U.S. Treasuries is not or should not be the bank's role in the economy.

Finally, many of us in small business believe that a plant and equipment-based program, although being a great start, could leave many of us short by introducing a lending bias toward hard goods and may penalize high-technology and engineering-oriented companies that are, in fact, creating a large portion of jobs and export earnings. We just feel it should go further.

Thank you very much for this opportunity to present these views to the committee.

[Mr. Pinkerton's statement may be found in the appendix.]

Chairman LaFalce. Thank you, Mr. Pinkerton. You make a very good point. It is one that I am cognizant of, and I am attempting to deal with it. The only question is how far can we go, how fast. If you are dealing with something that is more easily collateralized, the potential for securitizing it is easier, and we are working on that at the outset.

Mr. Pinkerton. Yes.

Chairman LaFalce. Our next presenter, Ms. Suzanne Fairlie, Prosearch, Inc., Conshohocken, Pennsylvania.

TESTIMONY OF SUZANNE FAIRLIE, PROSEARCH, INC., CONSHOHOCKEN, PA

Ms. Fairlie. Thank you, Mr. Chairman.

Chairman LaFalce. I went to Villanova law school, not far from Conshohocken. I used to study in the library until 11:00 and then go to a place called Wally's in Conshohocken for a Philadelphia beef steak sandwich.

Ms. Fairlie. It is still there.

Chairman LaFalce. Wally's is still there?

Ms. Fairlie. I will send you one.

Chairman LaFalce. OK.

Ms. Fairlie. Thank you, and also all members of the committee for allowing me to share my personal experiences regarding my declining access to credit as my company became more successful.

I am Suzanne Fairlie, and I speak as a small business owner in the services sector. My purpose is to help you understand the repercussions of the existing structures that make it difficult for small business owners, male or female, who are in the business services group.

I am the 100 percent owner of Prosearch, Inc., a Sub S corporation founded 5 years ago as a permanent placement firm specializing in high technology personnel to Philadelphia's Fortune 500's. In other words, we are headhunters, and we place computer people in companies like Smith Kline, Morgan Bank, ICI America, and duPont. These are strong clients. We were recognized locally in our third year of business as one of the top 25 search firms in the industry for the Philadelphia area.

Women-owned businesses now employ more than 11 million people; more than the Fortune 500's, and yet we face significantly more difficulties in gaining the access to credit that we need to grow our businesses. Many of these credit problems are not because we are female, but because we are in the services industry as opposed to manufacturing and other areas with inventory.

My annual gross sales in 1992 were higher than 64 percent of the other firms surveyed in a recent survey that is being included in the U.S. Census Bureau. We are in the $500,000 to $1 million dollar category. Our payroll and our sales increase last year of more than 20 percent also put us in the top 25 percent of the firms participating in this survey.

The reason for stating this is to have you understand how the bank saw me as a business when they were talking to me. Pro-search and many small businesses like it are major participants in the growth of our economy in a time when many firms are down-sizing, going bankrupt, or just not growing. In showing a profit for our employees, we are encouraging more spending on goods and services in our country.

At the end of the first 6 months of business, it was clear that my business showed a strong likelihood of being successful, and I went to my neighborhood bank where I asked for a small loan, $25,000, just to keep me going for the next few months. I showed them my client list, my receivables list, my 20 years of history in the computer field in firms like IBM and Sun Oil. They said yes. The banker took the time to understand the placement industry, who I was, and who my clients were, and they authorized a loan large enough to keep me going and to give me total ownership of the company.

I had started the company, by the way, with a $25,000 loan from somebody who had nothing to do with the business. He said, "Here is $25,000; get started. Pay me back at 15 percent, and give me 50 percent ownership of the business." That was not a good deal after I really got into business and saw what I was doing. So, I am now the sole owner.

In the meantime, I put all the money earned back into the business to buy startup equipment, office furniture, rent in a decent area—there are nice buildings in Conshohocken today—rent, stationery, advertising, so that we looked like a strong, successful company instead of the small company of three employees that we really were.

The sacrifices were worthwhile because the company would make it if I invested all the money earned back into it instead of into my pocket. The bank later said this had a lot to do with their financing me that first year. However, many women do not have credit card history established at high enough levels to allow them the privilege of paying 23 percent interest on the balances we incurred, or do not have a husband whose salary can pay the basic mortgage and food.

Five months later, I again went to the bank for a computer system needed to grow the business, and again showed my receivables, which were now about four times the amount that I needed, my previous year's financial history, and my client list. Again, the bank agreed to the loan.

In my naivete I felt very comfortable, because I felt that this established good credit history if I should run into future credit needs. During this time I met with my banker frequently, sent her newspaper clippings about the company, and we got to know each other well as banker, adviser, and client.

A year later I ran into a cash-flow problem, and, again, it was because of invoices lost by a major corporation. Not the Government, but a Fortune 100 in Philadelphia. The cash-flow was only 30 days in duration, but it made me realize the need for a credit line, something I did not have at that point.

My bank in the meantime had merged and was swallowed up by a much larger bank that was not known for its understanding of

small business. They explained to me that I would need collateral to finance the credit line, that the furniture and credit history that I had accumulated to date were of no value to them. My receivables were no value to them if there was not hard core collateral.

This may make sense to you, but to many women who have been the sole supporters of their family for years, collateral in the form of real estate or financial instruments is nonexistent. Again, I was fortunate in that I had saved stocks and bonds from my work at IBM and Sun, and so I offered these in exchange for the credit line and continued the company.

In 1992, the company was now 5 years old. We had shown a strong record of growth and credibility. I had never been late one day with any bill or payment for any of my vendors. To my surprise, out of the blue, the new banking organization called me, said they would like to meet with me to discuss my credit history and to discuss consolidating the two loans, even though one was almost completely paid and the other would be paid off in full in less than a year.

I was flattered that this large bank wanted to come to my offices and meet me. But little did I realize what was about to happen. They told me they wanted to change the terms of the loan. They would be forced to call the loan and reissue it as a second mortgage on my house. When I asked why, what I had done wrong, they explained the new policy was to issue no loans without collateral. Even though these loans were almost paid off, even though I had never been a day late with any payment and the business was growing, they said, "tough."

I asked what my alternatives were. They said "not too many." I explained that my husband was using the real estate we owned as collateral to expand his offices. He is a psychologist whose offices are in a wing in the house. The bank firm replied unless I was willing to use the property, I should just stop bothering talking to them and call a new bank. That's what I did. I could not ask my husband to stop the construction of his new offices, and the bank refused to work with me. I found another bank that was willing to refinance the very limited debt that I had. In exchange for this, I had to pay prepayment costs on the old loan, pay new points on the new loan with the new bank, not for one penny more of new money, and spend many days, weeks, researching new banks, during which time I was not contributing to the revenue of my company.

At the time of this situation, I had a receivables list in excess of 40 percent of the loan, had not experienced one bad debt from any of my clients, and most of my clients had a payment record of 30 days. Despite this track record, I would have been faced with bankruptcy. I had no other family to go to for finances, and, yes; women do go to their family for finances more so than banks. We had two children in college at the same time, and so all of our savings were earmarked at that point.

I do not think the Government wants to force small businesses that are successful to go under. Yet, that is exactly what this practice of demanding real estate collateral from service businesses is doing, even though the service industry makes up 40 percent of our small businesses.

I went to the new bank 5 months ago to request a loan to purchase furniture for expansion. I have now reached the point where we are turning away clients, the revenue is stable, and I need to add three more recruiters. I have to give them space to work in. I only wanted a loan of $16,000. SBA said they would not talk to me for less than $50,000. The bank said I needed real estate collateral. Forget it. There is no collateral in the credit history of the company or the client base. So, I have been forced to go to a leasing company where my interest rates are almost double of what the larger companies are paying.

I am one of the lucky business owners. We are still growing well after 5 years. Before starting the business I had already established a credit card history, and I was married to an understanding husband. To be a successful business owner in the services industry, the criteria should not be to marry an understanding spouse. Rather, character loans for those business owners who have an established client base, successful credit history, and a large receivable base should be the criteria to allow this growing sector of the economy to continue growing.

If you are really committed to the concept that small business is producing the jobs in this country, please act on your obligation to ensure access to credit for the services sector.

Thank you.

[Ms. Fairlie's statement may be found in the appendix.]

Chairman LaFalce. Thank you very much, Ms. Fairlie.

I am now going to ask Congressman Glen Poshard of Illinois to assume the Chair in my absence.

Ms. Fairlie. OK.

Chairman LaFalce. Thank you.

Mr. Collins. I think this lady is a smart business person. It is good to marry an understanding spouse. I did.

[Laughter.]

Ms. Fairlie. They help.

Mr. Poshard. The chairman indicated that he has a meeting at the White House and has to leave, and I apologize for having arrived at the hearing late. We have two subcommittees going on at the same time this morning. It is not unusual around here. We are trying to look at some reorganization in the Congress to make that less impossible than it presently is to keep up with those things.

Ms. Fairlie, let me ask you something, if I may. We still have sort of a debate raging in this country about interstate banking and the ability of larger banks to come in to smaller communities, especially to put in branch banking and so on. You had indicated that your local bank, with whom you had been doing business, had been consumed by a larger entity, and those people became less understanding.

Were they also less knowledgeable of your operation at the time?

Ms. Fairlie. They knew nothing of the operation.

Mr. Poshard. OK.

Ms. Fairlie. They did not want to. When they came to the offices, they wanted to talk small talk and joke, which is not my style of doing business.

Mr. POSHARD. So, they were going by the book that had been given them by someone in central administration farther away from your community.

Is this a problem for small businesses generally, and I am assuming that most of you are in what, medium-sized communities or smaller around the country?

Mr. FEDOR. Mr. Chairman, I would like to comment on that.

Mr. POSHARD. Yes, sir.

Mr. FEDOR. The makeup of the asset-based lenders, in fact, most of the lenders in the banks today are very young, inexperienced people, and the experienced bankers, those who are in their 50's are out on the street. It is a great tragedy, because when we are dealing with complex issues of bank or banking particularly for work in process, they just do not understand the collateral base for work in process.

When they walk into a manufacturing facility, they are just scared to death. They just completely do not understand it, and we lost that. Somehow we have to reconstruct that.

Mr. POSHARD. So, you are seeing lesser experienced people in the banking industry now dealing with small business people, and you are feeling a loss of that experience in the banking industry that has normally dealt with you on a character basis or on an accounts receivable basis or whatever?

Mr. FEDOR. That is correct.

Mr. COHEN. Mr. Poshard, I believe that my testimony occurred before your arrival. I am probably the one person up here who has not had personal problems getting money from the bank, but I am an adviser, and have been for in excess of 30 years, to small businesses serviced by our CPA firm.

I am happy to hear all these war stories related, because they are continually occurring throughout our community, and from talking to colleagues around the country, it is happening everywhere. Bankers are not interested in making loans. They are interested in buying other banks. They are interested in improving their balance sheets. While many of the banks have had record years in profitability in this last year, they have refused to lend good companies credit that they absolutely needed to continue expansion, and I am talking about good companies.

You have a situation in existence where there is a disincentive for banks to conduct the business for which they were really formed, and it is costing jobs more than I believe the President believes, and it is happening everywhere.

There is one point that has come out only indirectly. When a bank changes a policy and you are asked to find another bank, that is like putting a great big letter on your forehead. When you are looking for a new bank, it does not matter how good you were at the old bank. If you are looking for money for a new project, I found that everybody turns you down, and the only chance you have is to have one bank say yes; and then they may start competing and cutting rates. But, essentially, if you have been turned down or asked to leave by a bank, then you really have a very serious problem, regardless of any other fact.

The bankers blame it on the regulators. I am sure that there is plenty of truth in that. But meanwhile, somebody in Washington

has to take some notice and do something, and interstate branching is certainly not going to help small business.

Mr. POSHARD. So, even though you may eventually find a bank to get you the line of credit that you need, you still end up with a black mark on your record, so to speak, if you have to go through this process.

Mr. COHEN. Well, not with the new bank, but you are not going to find a new bank. That is the problem.

Mr. POSHARD. Right.

Mr. COHEN. I mean, you could be a good credit, but the bank changes its policies. They no longer want to make construction loans as in the example that was just given.

Mr. POSHARD. Yes.

Mr. COHEN. So, then you go to look for another bank, and you are going there with the onus of having been asked to leave your existing bank.

Mr. POSHARD. Right.

Mr. COHEN. Especially when there are so many, it is a supply and demand issue, too. The banks are making a few loans. Everybody wants the same dollars. So, the banks can cherry pick the loans they want.

Well, why would they ever go to somebody who has been asked to leave another bank? Why would they bother to look into the facts?

Mr. POSHARD. Sure.

Mr. Collins, you had some questions?

Mr. COLLINS. I just wanted to expand on that.

I am a small businessman. I still have my small business even though I am serving in Congress. I have been for 31 years, starting out at the age of 17. So, I walked many a path that you all have walked also. I live in a small town in middle Georgia. The county itself has less than 15,000 people in it. Two thousand of them are State inmates, so they do not add to the production of the county. [Laughter.]

Mr. COLLINS. But I am fortunate to live in a small town, because of having a community bank as well as a—I call it a big bank. We had Citizens Southern Bank of Georgia, later bought out by—it is now NationsBank, and I personally experienced some of the things that you went through, and have seen the times that I felt like they were there in that little town to reap the deposits that they could send to the bigger town called Atlanta, and lend out to the big companies, the big guys on the block, and let us little guys just make deposits.

But, fortunately, in a small town everybody was born and raised there, and they have known me all my life. We have a community bank. The community bank, I think, is a very valuable asset to rural America.

I read a book one time that was very interesting. It was how a son of a gun could succeed in business, and Mr. Nice Guy always finished last. One of the provisions was to find you a bank that you could get so deep in debt to them that they could never say no.

[Laughter.]

Mr. COLLINS. That is true. It works.

Thank you, Mr. Chairman.

Mr. POSHARD. Mr. Huffington.

Mr. Huffington. I do not have anything.

Mr. POSHARD. Thank you.

Mr. RENNIE. Banks are a lot more cooperative when you owe them a lot of money.

Mr. POSHARD. Right.

Ms. LESCRENIER. Mr. Chairman, may I——

Mr. POSHARD. Yes, ma'am.

Ms. LESCRENIER. I do believe you missed my testimony, but in it I stated that we had to repay a bank loan because for one month we were out of the loan covenant, the formula, and it was indeed a local bank controlled by an out-of-state through mergers, an out-of-state central headquarters, and they had issued very strict regulations. So, indeed, you are correct.

Mr. POSHARD. Thank you.

Just before we leave, Ms. Fairlie, I just wanted to make sure I understood one point. One thing that would be helpful is if we could find a way to help banks get away from demanding the real estate collateral and, instead, use the accounts receivable as part of that.

Ms. FAIRLIE. Right.

Mr. POSHARD. That would help your situation.

Ms. FAIRLIE. Which they did do initially.

Mr. POSHARD. Right.

Ms. FAIRLIE. When I was really a risk, when I was most at risk, when I was 6 months old, they were very comfortable doing it.

Mr. POSHARD. Yes.

Our next witness is Mr. Ratcliffe.

TESTIMONY OF RICHARD RATCLIFFE, CHAIRMAN, RATCLIFFE, INC., WEATHERFORD, OK

Mr. RATCLIFFE. Thank you, Mr. Chairman. I feel like my testimony is going to be quite a bit different, and I would almost like to alter it at this point, because I have some bank references in there.

[Laughter.]

Mr. RATCLIFFE. I want to give you a 30-second background on Ratcliffe, Inc.. By the way, we are in Oklahoma, although the agenda lists Ohio. We are from the land of tornadoes and floods. We have had it this spring.

But myself, I am the chairman of a family retail corporation, and my brother, who lives in Norman, Oklahoma, my son, and I, we probably do not work as much as congressmen do, but we do spend 10 hours a day and most Saturdays at our business. My father started this campus-store-type business in 1925, so it has been there a long time.

My brother and I have perpetuated the original business into eight retail stores in four different Oklahoma cities. We have diversified, however, from a college store plan into office products, athletic stores, sheet music. The biggest of our stores is a medical bookstore at the OU Health Sciences Center campus in Oklahoma City.

We have recently acquired an SBA loan for the new site in Oklahoma City, and it is being completed in July. It is being constructed as we speak here, I hope, if the rain is not too deep.

My comments are about the financing of that new building into which we will move our 13-year-old business on that campus. To acquire the financing for the new site, we really had a test of patience, I think, and our credit, even though is excellent with our company, we have little or no debt, and we wanted to use a conventional bank loan for these purposes.

As soon as our project was announced, several lenders contacted me offering their bank as a source for funds. We narrowed the field down to two, and both of those final two were SBA-approved lenders. We began negotiations on terms and interest, and this is where it gets a little tight.

The SBA guarantee, of course, was required because we wanted a 15-year fixed interest loan, and that is not available through conventional banks at this time. Negotiations were terrible. We refused to sign several of the requests for personal guarantees. Our attorneys agreed that we had way too much collateral for the loan as agreed. We capitulated on several of those points, but finally refused three of the required items, and that is kind of where the deal stalled.

The bank, the SBA, and Ratcliffe have now signed a lesser loan agreement, which we are all happy with, I think. But in doing that we have delayed the contractor for almost 2 months, and he is behind schedule now.

Now, the part of my testimony that may be dangerous among this table is I also served as chairman of the board of directors, or have served, of a local bank in my community, which is Weatherford, outside of Oklahoma City, until last year when FDIC's new Reg. O, or Regulation O, convinced me to resign the chairmanship and maintain my directorship position.

The FDIC Improvement Act, Reg. O, if you are familiar with that, puts limits on officers borrowing, and my company needs from time to time lots of borrowing. The new Improvement Act allows me as a customer—not chairman—and a director—not chairman—to borrow maybe as much as five times or more than I would as chairman. I think that is ironic almost. Same guy on either side. All I did was change offices.

But my company, Ratcliffe, is prohibited by regulation from borrowing the amount of funds we needed from my local bank, because of the FDIC Improvement Act, by the way. Now Reg. O has been modified to allow a little bit more in the surplus and capital structure for officers. So, we just last week had a little bit of change in that.

My central comments about borrowing would be that lenders, whomever they may be, tend to collateralize at extremely high risk to the borrower. The borrower is at risk. My company has several millions pledged to secure a $600,000 loan, personal guarantees, et cetera. We knew we were being forced to pledge too much, and I addressed that earlier. I will skip that testimony.

I am going to switch hats now and kind of go on to the banker's side of this, because I do have that experience, too.

The question is would I, a bank director, want to make a business loan with less collateral than they are making now? The answer is, no; I would not. In fact, I probably have cast more no votes on business inventory loans than any other member of my local loan business committee.

The simple reason is the regulators or examiners, who started in our bank Monday morning, by the way, the State examiners on their regular audit path, are going to criticize the business loan, and perhaps they will even classify that business loan as substandard, which, if you are familiar, is a critical classification. If they do not classify the business loan, I can almost guarantee you that they will find several technical exceptions, or TE's, at this audit because of the document required to do a small business loan.

To end this up, I want to summarize that the Committee on Small Business is working on the right problem. I thoroughly agree with the availability of small business credit. That is great. I do not agree that Velda Sue will solve the problems in rural America. I want to tell you I am just visiting with you about rural America here. In my opinion, President Clinton is correct to support less regulated business loans, call off the regulators, and more emphasis on character loans. The banks have that space. I am convinced that we are good guys.

Second, businesses our size need more small loans than large loans. As you have heard today, operating loans help the business survive by providing the funding for the hills and valleys of day-to-day business. A good plant and equipment loan without operating cash is almost a certain loss. You have to have that small operating loan to get through.

If you fully secure a Velda Sue loan, SBA loan, a loan of those types, then what will the small businessman have available to use as collateral to get an operating loan? We do a whole lot of cattle loans out there where we are, and cattlemen borrow money to buy the cattle. Guess what? They have got to feed those guys. So, we loan operating lines to those.

Third, and finally, I vote on small business loans every Thursday morning at our discount meeting, and 7:30 in the morning I will be in Weatherford doing that again. Let me tell you very few business loans that are presented are what we would call good. Most are risky, and most require the bank's constant attention. Several are refused with their presentation and referred to business advisers in our community.

I think that the availability of credit is there. I do not think that we are short on credit. But the borrower and the lender are subject to too many requirements from the Feds to secure that loan.

Thank you very much.

[Mr. Ratcliffe's statement may be found in the appendix.]

Mr. Poshard. Thank you, Mr. Ratcliffe.

May I ask you a couple questions?

First of all, on your particular loan, who was it that was demanding the overcollateralization? Was it a combination of the SBA and the local bank, or was it one or the other that was predominating in that process?

Mr. Ratcliffe. In anticipation of that question, I brought the loan request punchlist, if you will, page after page, a very fine writ-

ten document. Anything that did not appear in the SBA request, which is coordinated through the SBA lender bank and the SBA office, they know exactly what they are going to ask for. The last two pages are bigger type. They are the things that the bank lender thought we ought to do on top of the SBA loan.

So, yes; there is quite a list.

Mr. POSHARD. So, it was a combination of both then?

Mr. RATCLIFFE. Combination of both.

Mr. POSHARD. The bank actually went beyond just to be safe?

Mr. RATCLIFFE. Yes; I still want to comment as a banker that all they are doing is what the regulators are demanding. I will tell you, if you cut the regulations, these guys will loan some money.

Mr. POSHARD. You felt like you were required to be way over collateralized to get your loan. Would you have approved lesser collateral for your loan if you were on that bank board?

Mr. RATCLIFFE. Absolutely. I mean, I think that we could have taken the building that we are new building. We asked several people is our building going to be worth more when we turn the key or less when we turn the key. They all said your building, where it is, next to the campus, will be worth more. The bank would not take the building at all for collateral. I mean, as total collateral. They said we want the building. We want this. We want you and your wife, and we would like some of your children.

Mr. POSHARD. I want to clarify that your testimony is that, as a director on the bank board, you are being overly cautious about the loans that you sign off on because you are afraid the regulators are going to come in and penalize the bank?

Mr. RATCLIFFE. We are not afraid. The regulators are there.

Mr. POSHARD. I understand. But it is that bad?

Mr. RATCLIFFE. I would not sign off on a loan without just completely doing the punchlist, because you are going to get written up. You are going to get classified. They will check with me—the president—and they will say you have got to have this in place. Then we go to the borrowers, like you have heard here, and say, we have got news for you. The regulators want this document. Well, you cannot have that.

Mr. POSHARD. Put yourself in my place now, or that of any Member of Congress having just gone through an absolute bludgeoning by the public over the S&L crisis, because we were too lax. We did not keep our oversight function in place. We let folks give loans to very high risk, who were supposed to be dealing in the local communities on houses and those kinds of things, and instead they borrowed money for condominiums on the coast and all kinds of other things.

There are several banks in the country that are at risk right now, and the public has a great fear. We keep talking about the President advocating a tax increase. My gosh, do you realize the largest tax increase in the history of this country came from the S&L bailout; that it is a hidden tax? Nobody even thinks about that.

What would you do if you were in Congress? Would you continue to tell those regulators, hey, keep them tight, we do not want to pay? We are dealing with the taxpayers' money here. We do not

want to have to go back and borrow another $250 billion down the road to pay more losses.

What would you do if you were in our seat on these kinds of things when they come up? We are supposed to be reasonable. We want to make it possible for you to get money, and to give the regulators the right to say, sure, this is enough collateral. We do not want to charge you six times to set aside here what you need for the loan. But where is the middle ground?

Mr. RATCLIFFE. Mr. Chairman, I am going to answer that maybe in a surprising way. But I think hearings like this are the answer. Our community lost three savings and loans in that debacle, if you will, and I guarantee you there is not hardly anybody in our community who did not know that there was a problem in there. They were making loans, in savings and loans that should never have been made. A guy off the street knows not to make that loan. We have example after example, I will not go into that. But I promise somebody could have told Congress, and perhaps did, that we have got a problem here and it should be addressed at that point.

I think public forum is an answer.

Mr. POSHARD. Thank you.

Mr. Huffington.

Mr. HUFFINGTON. Mr. Chairman, I am delighted to be here with all of you. I am a small businessman also, and I had the experience of working in a bank in Chicago at one stage, so, I have some experience with banking.

The S&L industry and the banking industry are two different industries. One of the reasons the S&L industry had such major problems is there were some developers who took over S&L businesses so that they could have money for their own specific projects.

I know when I got out of school it seemed to me, at least, the S&L management was never quite as good as commercial bank management. So, I think that is part of the reason the S&L's had such major problems.

I am also on the Banking Committee. I do not know why anybody would want to be a director of a bank today, because when people come after you, they are not just coming after the bank, they are coming after you individually. All of your assets are at risk. So, I can see why directors in particular are very risk-adverse, because their house is on the line. Their kids future is on the line in terms of their assets and that is one of the problems.

I think the regulators have gone too far. You have your own problem with business regulations in environmental areas and other things, but we are talking about credit crunch today rather than your own specific over-regulation by many of the agencies in this Government.

I have heard banks turn down some very good loans, and they should not. I think part of the problem is the fact that people are concerned about what happened to the S&L's. They do not want that to happen to the banks, and we have probably gone too far, in my opinion; too far.

These meetings are beneficial. In fact, we almost ought to have a joint Banking-Small Business Committee meeting, because the relationship is intertwined. But at least this is a good start.

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I just wanted to thank you for coming. Really, it is important for all of us to hear your individual experiences, because only you had them. We cannot know everything. So, thank you for being with us.

Mr. COHEN. Mr. Chairman, may I make one other short comment?

Mr. POSHARD. Yes.

Mr. COHEN. I was once told that if you want somebody to do something right, you reward them for doing something right and penalize them for doing something wrong. If you do not utilize that system, you are not going to have a solution.

Right now, the first thing is to recognize that there is a problem, and maybe we have already gotten to that hurdle. The next thing, and I cannot provide specific answers to Congress as to what to do, but you have to create a system where banks benefit from and have incentive to find good small businesses to lend money, earn interest on those loans, and help the economy prosper, and to penalize them for avoiding lending small business money.

I do not know how you do that, but right now we have the opposite effect. If they do what is right, they are penalized. If they do what is wrong, they are rewarded. As long as that system is there, we are just not going to have success. Whether the reward or whether the penalty comes from the regulators who are overzealous, or whether the reward comes from diverting money into Government securities or for buying other banks or whatever, it is irrelevant. You have to find out how to create the incentive and the penalties in the right directions.

Mr. POSHARD. I think your point is well taken, Mr. Cohen. I think, between the Banking Committee, the Small Business Committee, and, perhaps, some of the other committees here, we are searching for that middle ground. We do not want to create an atmosphere in the banking industry that is totally risk-free, enabling banks to be very profitable through Government securities and ignoring the legitimate concerns of small businesspeople who may very well have not only a need for a loan, but also have quite adequate collateral to back it up and not be able to get it. We are searching for that middle ground. Whether it is regulations or whatever it is, it needs to be changed. I am confident that in time we will find it.

Mr. COHEN. But in my opinion, the risk that they are evaluating is not the risk of losing money on the loan. It is the risk of the loan being classified, their balance sheet being affected, their formula for borrowing from the Fed being affected, and all those things that ought to be irrelevant.

Mr. POSHARD. I understand, and I think Mr. Ratcliffe has pointed that out very adequately in his testimony.

Mr. Collins.

Mr. COLLINS. I wanted to comment on Mr. Ratcliffe. I think he is right on target with the fact that regulations have caused a lot of the problems, but also the interpretation of those regulations by regulators who come in, and it is kind of like putting a badge on some folks. It kind of gets them steamed up. They can do a lot of things, and they have the ability and the authority to do such.

The S&L downfall, as my colleague from California mentioned, came about by some who were selfish in their actions. They got out on the limb with their investments. They were crippled by the 1986 Tax Code changes which knocked the props out from the real estate market. I think in order to address that, we have to address the economy and go back and reverse some of those actions that were taken with the 1986 Tax Code changes.

Now, Mr. Rennie was a good example of risk and regulator's interpretation of risk. His customer was the U.S. Government. Well, look at the U.S. Government. Its board of directors, which is Congress, has spent it into a $4 trillion debt, and expense in excess of its income annually over $300 billion.

Would you lend money to a customer like that?

[Laughter.]

Mr. Collins. You do not have to answer that.

Mr. Pinkus. No; but it gets back to a banker who will loan you so much money that you can control what he does.

Mr. Collins. Cannot control the U.S. Government.

Mr. Poshard. Mr. Collins and I could sit here and debate that question for a long time. We probably come from a different philosophical bent on that. But, when you talk about the economy in general, or the debt in general, we have gone for well over a decade in this country with an executive branch that has told the American people you do not have to pay for anything, which is absolutely ridiculous. We have gone for more years than that with a legislative branch that has told the American people you do not have to do without anything, and that is equally ridiculous. Between those two irresponsible philosophies, we have gone $4 trillion in debt.

Finally, one of these days, we will decide to go back home, and tell people when the roads are falling through, you are going to have to pay for them now, and quit borrowing money, and put it on the backs of your kids, and when the education system and the health care system is floundering on its back, you have to find a way to support that now. When we are willing to do that and be honest with the American people, we will start digging out of debt. When we are willing to stand up to the special interests in this place and tell them no once in awhile, you cannot have this project or program, it is not a priority in this country, we will start digging our way out of debt.

But I do not want to lay the blame on the economy right now or the debt in anybody's doorstep. We are all culpable out here, and I think both parts of the Government have their own individual responsibilities to clean it up.

But, nevertheless——

Mr. Collins. We have a responsibility there too, Mr. Chairman. I really do. I think you are right on target. It is time to stand up and say no to a lot of these special interests, and I hope some of that is going to be coming within the next few weeks as we put forth the budget process. However, I do not see a whole lot of it. We tell people we think they should sacrifice more and send in more contributions so we can invest those funds for them under the pretense that we are going to reduce Government spending when in the same budget resolution that was adopted the other day from the Conference Committee it included and projected a debt at the

end of September 30, 1998, of $6.182 trillion; over $300 billion again, year-after-year increased deficit spending.

So, we are all irresponsible if we think we can take that and make that work.

Mr. POSHARD. I want to reiterate that without that budget resolution that passed we would be $500 billion further in debt than what the present situation would be if we did nothing. So, I think we have to give the President some credit for at least beginning the process to reduce the deficit. No one out here can possibly think that we are going to reduce the debt right now. You are not going to take $4 trillion out of a $1.5 trillion budget. But nevertheless you have to begin somewhere.

Now, I want to get to Ms. Frankie Snead, who is with Red Rose Excavation, Inc., in Houston, Texas.

TESTIMONY OF FRANKIE SNEAD, RED ROSE EXCAVATION, INC., HOUSTON, TX

Ms. SNEAD. Thank you for the opportunity to meet with you this morning to express our ideas and hear your comments.

In 1986, I decided to invade the men's club and get into construction, and did quite well in that area. We pursued environmental remediation in 1992 and, after a long struggle, got a contract doing environmental remediation. But we needed additional financing to cover that contract for the first 3 months. It required a larger outlay in equipment and the taking on of additional personnel.

So, I went to the bank. I did not ask to finance the Gross National Product. I merely wanted $40,000 in operating capital. I was told that although I had 90-percent equity in my equipment, they would not use that; that although I had $300,000 in current receivables, they did not want to loan on receivables; and they did not want to loan against the contract at hand.

So, I was left with one other option which was to have my husband cosign for me. Little did they know that as a WBE that jeopardizes my minority status. So, I cannot have my husband cosign a loan at the bank for me.

At that point in time, we pulled in all the extras. We tightened the bootstraps. We went to our creditors, and asked for an extension in our terms, and we did the project without the bank, although it required 4 months of really getting skinny.

I do not know what the solution is. I am not a banker. I do not want to be a banker. I do not want to talk banking all the time. I merely want to move dirt. But I am willing to do whatever is necessary in order to change whatever regulations are keeping us from getting quick money, small money, easily.

Mr. POSHARD. Ms. Snead, Ms. Fairlie before you suggested that it may be more difficult for women- or minority-owned businesses, whether they are in the service industry or, in your case, construction, to get loans at banks for whatever reason now.

Do you think the banking industry is less sensitive or less aware of the peculiar position of women- or minority-owned businesses today? Is it more difficult for you to deal with banks? Do they not put as much trust in you?

Ms. SNEAD. I think we are still considered a second-class citizen when we go to the bank. We are not taken seriously as a business person or as a business enterprise. We still have to have the man behind us in order to be financially sound. Although I have a greatly supportive husband, he has never had to stand behind me in the business, and I did not feel he had to stand behind me at the bank either, and I was incensed that they would imply that he needed to.

Mr. POSHARD. Did the bank know before they suggested it that you could endanger your minority-owned status if you had gotten your husband to cosign on that?

Ms. SNEAD. No; they have absolutely no idea of what is required in order to obtain that status, or to maintain it.

Mr. POSHARD. Mr. Collins, did you have any questions?

Mr. COLLINS. No questions, Mr. Chairman.

Mr. POSHARD. Thank you, Ms. Snead. I appreciate that, and remember, folks, that this is an informal hearing. I know it is going on a little bit, but jump in if you have something to add here. It is OK. There is no problem.

We will hear now from Mr. David Pinkus, who is president of Small Business United of Texas, in Austin, Texas.

TESTIMONY OF DAVID PINKUS, PRESIDENT, SMALL BUSINESS UNITED OF TEXAS, AUSTIN, TX

Mr. PINKUS. Thank you. I would just like to comment, first of all, that I feel, from the remarks that you all have made and some of the remarks that Chairman LaFalce has made in the past, that you have a pretty good understanding of what the problem is.

Today, I am not going to tell you special war stories about my business, although up until about 6 months ago I was a small businessperson. I just want to tell you that about 2 years ago I was at a meeting of National Small Business United, and I was sitting with a friend from Connecticut. I mentioned to him that our business, which is a family-owned business, and is still in business, was in business in Texas for one reason and one reason only. That is because we happen to be fortunate enough to be banking with the only bank, the only major bank in the State of Texas that did not fail.

So, when you talk about the savings and loan debacle in Texas, it also reached over into the banking industry in very major proportion.

We have concerns about community banks and community lending, and I think that what we have been doing as an association with Small Business United of Texas is trying to study the problem of access to credit within the State of Texas, and find some solutions, and recommended solutions. I would like to share with you some of the things that we have uncovered or discovered.

First of all, I had the opportunity back last October to testify at some hearings that were being held by the Office of Thrift Supervision. They went around the country holding meetings very similar to this and having panel discussions. One of the things that was brought up—they had various panels—both by panels of developers, panels of small business people, and panels of bankers, was

that one of the major aspects was this hidden hammer or ax that was behind the necks of all bank officers and directors, which was at that time, and still today, lawsuits that are being processed by the Federal Government.

My testimony at that meeting was that I felt that most of the lawsuits that were being prosecuted were counterproductive and were really placing in jeopardy business access to business loans.

The response to mine and at least four or five other panelists from Director Timothy Ryan, who was Director of the Office of Thrift Management, was that the Federal Government will continue to press the course to accept a standard of simple negligence in the lawsuits against bank directors.

Now, in my opinion, simple negligence in a lawsuit really is ludicrous, because simple negligence in a bank loan can be as simple as not having updated the appraisal on a piece of property, not having had the right number of personal financial statements; not necessarily the kind of things that you would look at to make somebody grossly negligent or criminally negligent, which has been alleged in a number of cases.

Mr. POSHARD. Because simple negligence can just be a mistake that somebody might make as opposed to something not intentional and not trying to do.

Mr. PINKUS. I can tell you from personal, relatively personal experience, one of my best friends was a senior vice president of a savings and loan in Dallas, and he left that savings and loan in early 1986, before Congress passed the 1986 tax law and the real estate market went into the gutter. He just finished settling a $63-million lawsuit with the Federal Government on loans that he had made. In effect, he was forced to personally guarantee the loans that he had made.

There were no charges of either gross or criminal negligence on his part. He just happened to make some loans which in hindsight, 20/20 hindsight, were bad real estate loans. They were done in, I think, good faith. There was no—there has never been, as far as I know, any criminal charges made against anybody with his savings and loan.

The same thing has happened in Dallas with First Interstate or Republic National Bank, where the officers and directors of that bank settled for about $22 million.

Now, first of all, in my view, you have to be nuts to accept a position as a director of a bank or savings and loan today.

Second, yesterday we were at the White House, and the Comptroller of the Currency was there and talked about the policy that was issued this past March on reduced documentation requirements for small business loans.

Now, take this policy, and the policy of suing directors. If you were a director or a bank officer, would you comply with this policy? Absolutely not, because there is nothing to say that the fact that you decided not to require all the full documentation and have all that documentation in a file would preclude you at some future date, if that loan happened to go bad, to be sued by the FDIC or the Federal Government.

What the Federal Government is doing is sending mixed signals to officers and directors of banks. Be more lenient, but remember

that if you are too lenient, or at some future date if we decide that you were too lenient, you can be personally responsible for the decision that you made to be lenient and comply with the guidelines that we issued, and it is ridiculous.

The other thing that we had looked at is paperwork. I do not know if you have seen, a loan package for an SBA loan. But I have seen some that are in two-inch binders where you could not get another piece of paper in the binder in order to fulfill all the requirements.

We have already twice this year exhausted the allocation for 7(a) SBA loans, and we are in the process now of going back to the till for more. I see that really with the restrictions that have been placed on banks, and you can ease up on all the regulations that you want to, but I think that the threat of lawsuit is real. Why would anybody in their right mind as a banker want to make any kind of a risky loan, knowing that if the loan went bad, they are going to get sued and have to take money out of their pocket in order to make the loan good?

The only way that is going to happen is if you have Government-guaranteed loans, and that you have those loans approved by an employee of the Federal Government to take you off the hook. I think that is one of the reasons why there has been such an increased demand for SBA loans.

I know in Texas, talking to some of the district directors in Texas, SBA lending has doubled the rate that it was just a year ago, and I am sure that is happening in other parts of the country. The pressure is there to make small business loans, and really the safest loans for the bankers to make are SBA loans. I do not see any solution to the problem, if we want to put more money into small businesses, than to continue to have Government-guaranteed loan programs, and to expand those loan programs.

Now, to put those into perspective. I read not too long ago that the President's economic stimulus package would have cost approximately $90,000 per job created in Federal spending, and that is not that everybody was going to make $90,000, but people took the number of jobs that were projected; it was easy to do, basic math. You divide the number of jobs into the amount of dollars that was going to be spent, and it came out to approximately $90,000.

Mr. POSHARD. I would like to point out that quite a bit of the money in the President's economic stimulus program went to programs like Head Start, WIC, and other programs.

Mr. PINKUS. I understand.

Mr. POSHARD. They are not job-creating programs, but we do them for purposes of helping our children, and helping our society in general.

Mr. PINKUS. Yes; I understand that.

Mr. POSHARD. The infrastructure part was job creating, more or less. Anyway, I just wanted to comment on that.

Mr. PINKUS. I understand that. The point I am trying to make is that we have done some studying. In fact, back in 1987, when we examined one of the Texas small business loan programs that the State had, doing the same kind of mathematical calculations, we found that—these were actual State loans—in State loans it cost

about $4,700 in loans to create a job. I think in today's dollars, depending on the industry, you can probably create a job with about $10,000 in lending. It could be less, depending on the industry; it could be a little bit more. But that is $10,000 in loans, not $10,000 in expenses.

If you really want to create jobs, you can create a whole lot more jobs with a whole lot less in exposure and use of Federal moneys by expanded loan programs than you can with spending programs, and I think that you really need to take a longer, harder look at expanding those lending programs, because that is where the loans are going to come from.

A lot of questions have been asked, too, about the community banks. We got a report from the SBA through some wheeling and dealing. We got a complete list of all the SBA loans that were outstanding at the State of Texas as of January 31 of this year, and have been in the process of analyzing that report. One of the biggest banks, and I do not want to pick specifically on one bank, but I will, and I only want to do that because I got a copy of the report of the conference that the Comptroller of the Currency held last September. I want to read one paragraph here from a statement by the executive vice president of NationsBank from Dallas.

He said,

> We adopted a model that we have been piloting in San Antonio, Texas, for about 2 years. A bank we purchased there had been running the model for about a year before the purchase. We installed in the model in four other cities last January. Because the program has worked, NationsBank is now implementing it in markets across the United States. At present, we are confining the program to major metropolitan areas.

Now, we took a look at the SBA loans that NationsBank has made, and we look at San Antonio. In the city of San Antonio, at the end of January of this year, there was a total of 236 outstanding SBA loans. Of that 236, NationsBank, in their model program, had 31 loans, which accounted for a total of 13.1 percent of the outstanding SBA loans in San Antonio. Not too bad.

The same bank, or the same bank officers, had a similar program in Austin, where out of 241 loans NationsBank had 13, or 5.4 percent of the market. They did not have to go very far to go to Houston where out of 704 outstanding SBA loans, NationsBank had four. That is 6/10 of 1 percent of the outstanding loans in the city of Houston. There were 34 other banks in Houston that had more SBA loans than NationsBank.

Travel up the road a little bit to Dallas where there were 878 outstanding SBA loans. Of that 878, NationsBank had 7, which was 8/10 of 1 percent. The numbers are not a whole lot different for Bank One or Texas Commerce Bank, although they are a little bit greater.

In looking at the State as a whole, there are at least a half dozen community banks that have more outstanding loans in their communities than NationsBank has in the entire State of Texas. If we continue to go to branch banking, the community banks, and as we have looked through the things, it is real obvious that the community banks are where the small business loans are being made. I mean, just over and over again. I mean, there is a bank in Saquin, Texas that has over 200 SBA loans outstanding. There is a bank in

Missouri City, Texas that has over 100 outstanding SBA loans, and I can just go on and on to demonstrate that to you.

We have to maintain community banks if we are going to have small business loans. The big banks are not going to do it.

I think I am taking a little more than my time. I want to also relate to you one other story. Last Thanksgiving morning, I was visiting with a friend of mine who was a former banker who ran the small business division for 2½ years at NCNB in Dallas. I was talking to him about the project that we were looking into to improving bank access. He said, "Dave, I remember, I think I made a couple of SBA loans back when I was a loan officer." I said, "You must have made some when you were running the small business division down there." He said, "No; I did not make any loans when I was running the small business division." I said, "Well, Jack, what in the hell did you do?" He said, "Well, we spent the whole time," and he had a staff of about five loan officers, "reclassifying loans, because the bank made more money reclassifying a loan as a bad loan than they did in making new loans."

Thank you.

Mr. Poshard. Incredible.

Mr. Pinkus, thank you for your testimony. I have been involved in the health care crisis. As you know, we are hopefully going through some health care reform in this country. We do not know what direction it is going to take yet. Of course, the litigious society keeps coming up in this whole debate about health care reform. Now you are telling me that this is also affecting our ability to adequately lend money to small businesses, because, again, the fear factor that bank directors have of the possibility of being sued if they make some simple mistake, or whatever, in the process. I did not realize it was that serious a problem.

Mr. Pinkus. Mr. Ratcliffe could probably respond to that better than I could.

Mr. Ratcliffe. We have addressed that, and we have canceled our directors and officers insurance because it got completely out of hand. We are running kind of naked. We feel like we are in control of our own banking premises. Although it is hard to meet regulators' requirements, we still make every effort to do that.

Essentially what we are saying is if we are doing the best job we can, we are doing the best job we can. They really will have a difficult time proving that we were negligent. We are documented. We are making the requirements, and believe me, it is not the first time I have heard horror stories.

However, I wanted to comment that before I came, I measured my SBA file. Seven inches thick. That is about that thick.

Mr. Poshard. Are you in a community bank?

Mr. Ratcliffe. Yes.

Mr. Pinkus. Yes; and I think when you are looking at cutting down on the paperwork, we need to look at the way the SBA, what they require for paperwork.

Mr. Poshard. OK. Mr. Cowling wanted to respond.

Mr. Cowling. I would like to help you understand what your banker friends might have been doing. The only thing worse than a no is when you go to somebody, you have lunch, you provide them documentation, you talk with them for 2 hours on the phone, and

you visit them again. Then they tell you, "no," when they knew up front that they were going to tell you "no" when you told them. I am in this situation, should we go ahead with them or should we not? I would rather get a "no" right away than a no after all that work.

The second thing I would like to mention regarding community banking that you were talking about is that the Comptroller of the Currency yesterday talked about paperwork reductions for banks of, I believe, $500 million in capital or less. I would suggest, as abhorrent as I think regulations and so on are, that perhaps we tie a carrot to that, and if you are under $500 million, you can qualify for this if you have a local board of directors, if you have local loan committees, if you have some correlation between your source of deposits in the community in which you make commercial loans. So, I would suggest that as a specific example of something that you folks might be able to do.

Mr. POSHARD. Very good.

Mr. Collins.

Mr. COLLINS. Thank you, Mr. Chairman.

Mr. Pinkus and I met last night in my office, and we kind of compared notes. That is the reason he was so on target there with everything.

The CNS and Nations now in Georgia, we used to call them the "catch'em and squeeze'em crowd."

[Laughter.]

Mr. COLLINS. You mentioned the stimulus package which showed some $90,000 expenditures versus one job created versus $10,000 in a bank loan that would create a job.

I go back to the fact that that $10,000 borrowed is in the private sector to create possibly a productive-type job. There are a lot of jobs that would be created under the infrastructure portion of the stimulus package which we do collect funds, put into special trust funds for those infrastructure projects. But that $90,000, even though it had some good funds in it for such infrastructure, also had a lot of subsidy in it for social programs, which are nonproductive jobs. It only adds to the private sector jobs category.

I would like to ask Mr. Ratcliffe briefly, and then I am going to have to go. I apologize for having to leave, because I have really enjoyed this meeting this morning.

Give us a little information on the Community Reinvestment Act? Does that actually help in communities as far as loans?

Mr. RATCLIFFE. In the community that we are in, there are about 12,000 people in Western Oklahoma, an agriculture community, university town. 3M has three plants in our town.

I can elaborate on that, but we do things to meet those requirements that are not necessary. We are really sincere about trying to do everything that looks like it would be appropriate. I would have to say no.

Mr. COLLINS. Thank you.

Sorry, I am going to have to leave.

Mr. POSHARD. Thanks, Mr. Collins.

Mr. COLLINS. As the chairman said, we could debate the issue all afternoon, but when we part, we still part as friends. I was known for that in the Georgia State Senate. The majority leader upon his

retirement my first year in the State senate acknowledged the fact that even though we debated all day on the floor of the Senate, being of opposite parties, opposite philosophies, and opposite ideas, when we left, we left as friends, because we do have a job, and then we go about our regular lives.

Mr. POSHARD. Yes, sir.

Mr. COLLINS. Thank you very much. You all have a good day and thanks for coming.

Mr. POSHARD. Thank you, Mr. Collins, for your contribution to the hearing.

I have a meeting at 12:00, so we need to adjourn by 10 of at the very latest. I have one more question I want to throw out to the group.

Has the fairly dramatic decline in interest rates over the past several years done anything to alleviate the credit crunch? Nothing? Why not?

Mr. PINKERTON. The money is not available. The money is all tied up in Government securities. I think if you want to kick some of that money loose, penalize the banks for that type of action by possibly increasing some taxes on the profits that they make on Government securities.

Why should they loan it to us, as small businesses, and take a risk with it, especially with the regulators breathing down their backs, when they can make a profit on their money risk-free in Government securities? That is where all the money is in this country.

Mr. COHEN. While the interest rates have declined dramatically, the range, the gap, the margin between what banks pay and what banks receive has grown, and, therefore, banks have become more profitable.

The problem with small businesses is, at least in my client base, I can tell you that most of our clients would love to borrow money at 10 or 11 percent, if they could get it. Right now it is terrific to have 6-percent money if it were only available, but it is not.

Mr. POSHARD. Ms. Fairlie.

Ms. FAIRLIE. I was very happy to get a $25,000 loan at 10 percent. I was not happy to not get a $16,000 loan at 8 percent.

Mr. PINKUS. I have been told by most of the State banking associations that one of their concerns is that a couple months ago interest rates started to go back up, and they felt that when the rates started to go back up, and went back up, that would make the investments in Government securities less profitable for the banks, and that the banks would actually have to start making more business loans, because they would make more money doing that. I think that it might be safe to say that the low-interest rates actually reduce the availability of business loans, rather than increasing them.

Mr. POSHARD. I do not know what percentage the Feds are charging the banks right now for Government securities. Is it 3 percent?

Ms. JOLICOEUR. It is 2.89 percent.

Mr. POSHARD. So, they made about 7 percent on your loan at 10 percent, risk free, and that is part of the problem.

Mr. FEDOR. Mr. Chairman, I would like to make a comment here.

Mr. POSHARD. Yes, sir, Mr. Fedor.

Mr. FEDOR. We are talking about numbers and so forth, but I think an issue here, the jobs issue, and one of the things that I find is the new, young lending officers do not really have a concept of what that means. What I try to do when I interview bankers is to just look at a business like ours that provides high paying jobs in the manufacturing sector, and we employ almost 100 people. I tell them to get in their car, and drive down the street in a middle class neighborhood, and see how long it takes to go past the houses where there are 100 families living. In addition to that, our company also supports probably another 100 or 150 families with the supplier and vendor support that we need.

So, jobs are the issue. I think we should not get too tied up in the numbers and the banking issues, and really get down to the root of it. Small business does provide the jobs.

Mr. POSHARD. Right.

Mr. FEDOR. The manufacturing sector, in particular, needs the support for creating wealth in our country.

Mr. POSHARD. Right. Thank you.

We will now go to Linda Jolicoeur, Target Equipment Leasing, in Southfield, Michigan. Welcome.

TESTIMONY OF LINDA JOLICOEUR, TARGET EQUIPMENT LEASING, INC., SOUTHFIELD, MI

Ms. JOLICOEUR. Thank you. I will depart from my prepared remarks in the interest of time, and just share informally with you my own experience with bank branching.

Last year, during the Washington presentation, the members of the Michigan delegation of NSBU and NAWBO, the National Association of Women Business Owners, had the opportunity to sit with Senator Don Riegle and his top aide on the Banking Committee. At that time, we shared our concern not only about the tight bank regulations, but we also discussed with them the effect of branching and what was happening in our area to small businesses as a result. Many people's lines were being pulled. Loans were being called in.

Again, young bankers were not quite as familiar with the industry. I do not want to pick on young people. They are not the culprits here. It is the regulations which they are trying to meet that are the culprits.

What we intended to do was share with Senator Riegle and his top aide the real life experiences that small business has when large banks come in with no local knowledge of the community.

Never in my wildest imagination did I dream that upon my return that my own warehouse line, which is much like a working capital line for other type of businesses—I am in the service sector, so I do not have a working capital line, but a warehouse line—had been canceled overnight without my knowledge.

I had sent packages down to the bank to be funded before I left for Washington. Upon my return, I was informed that, due to the merger of my bank with the second largest bank in the State, they no longer wanted to do business with leasing companies.

I had been with my commercial bank for 8 years, and had a half a million dollar line of credit. It was not backed personally by me. I

signed it simply as the only stockholder of the company, as president of the corporation. I never had to use my home as equity, or asked for my husband's personal guarantee, which I find very insulting.

Overnight, my line was just pulled. No explanation, other than they did not choose to deal with the leasing industry, which I think is unconscionable.

I have since been able to establish with a small savings bank a much smaller line of credit. I not only put up my house, but my husband also had to personally guarantee the line.

To me, this is unnecessary. We have had legislation passed, thanks to the Chair of this committee, the Women's Business Ownership Act, which was supposed to guard against things of this nature.

What I have found is that bankers tell me that, due to the regulations, they must ask for both spouses' personal guarantees on certain types of loans. I find that very difficult to deal with, and very difficult to understand, quite frankly.

The other problem that I found very, very prevalent in the banking industry is the classification of loans. Loans that are being paid by small businesses, many of them in the service sector, that have accounts receivables, that have purchase orders, and that have what lenders today term as soft assets. These are not soft assets in our opinion. As far as we are concerned, we pay our bills with hard dollars just like everyone else does.

It is quite insulting to be told by a banker that your accounts receivables, your purchase orders, your noncancellable contracts from your customers are not good collateral. We do not have plants, equipment, and commercial property that we can put up as collateral for loans.

I think that the regulatory agencies need to be brought into the current marketplace. Our technology is changing. We are moving from a manufacturing economy to a service sector economy that is of no surprise to anyone.

Yet, our lenders are stagnated by old regulation that no longer fits the marketplace. It does not fit the profile of their customers anymore. They are not meeting the needs of small business at this particular point in time.

Mr. POSHARD. Well, I appreciate that. We keep going back to this. I think that we probably need to go back and revisit women-owned businesses to see how the law is being carried out. If we have promoted in our own legislation, for instance, requiring a spousal signature or whatever, those kinds of things. We probably need to take another look at that.

But equally important, or more important than that, is that I agree with you. Our whole system has not adjusted or orientated itself toward the service sector economy. I think that is something that we really have to concentrate our effort on here.

Ms. JOLICOEUR. Absolutely. Erskine Bowles made a statement yesterday that small business was the engine of the economy. If that is the truth, then the fuel to small business is capital. We simply have to free up access to capital for the service sector.

It is not that I do not agree with what you are attempting to do through SBA loans or through Velda Sue, but those do not address

the needs again of small business that are in what lenders refer to as soft assets. They are not soft to us. We make our livings off of them, and we pay our mortgages with them.

Certainly, the contracts that I write in the leasing business are not only with small businesses such as the people sitting at this table, but I also write leases with IBM, Federal Mogul, Ford Motor, and many of the Fortune 500 companies. I do not consider that their contract, which is noncancellable, as being soft collateral or noncollectable. If I went out of business tomorrow, those companies would still under contractual obligation have to pay those payments.

Mr. POSHARD. Thank you for your testimony. I appreciate that every much.

We will now hear from Mr. John Giegel, who is with Wisconsin Business Development in Madison, Wisconsin.

TESTIMONY OF JOHN GIEGEL, WISCONSIN BUSINESS DEVELOPMENT, MADISON, WI

Mr. GIEGEL. Thank you, Mr. Chairman. I appreciate the opportunity to speak here today. All of our panel members today have reiterated the basic fundamental problems here, the overregulation of the lending industry in this country.

I run a private development company in Wisconsin. We are on our way to our third record year in lending. But we access the SBA's economic development loan program, the 504 Program. We appreciate the committee's foresight in funding us adequately, that we have funds now as opposed to the 7(a) Program.

But it also illustrated to me a fundamental problem that we have today. That banks are not in the conventional loan market. Wisconsin is up 50 percent in SBA activity over the last 3 years in a row. What that signals to me is that banks are no longer in the conventional lending market.

They are doing the treasury security routine. They use regulations to avoid lending. It is obviously easier not to make a loan and to buy securities and to not employ a commercial loan officer than to make a business loan.

Today, we have also seen the incidence of a larger bank, out-of-state banks in many cases, buying the local bank, and changing the fundamental philosophy of that local bank.

I can recite instances where a large bank took over a small bank, reduced the number of lending officers available to one person where there used to be four, and replaced the back of his desk with a long line of new bank lending policies.

What occurred though is that he never made any loans. Not only did he not have loan authority, but it had to be referred to executive committees in Minneapolis, or in some cases to Milwaukee. It really hinders the smaller community bank, the rural banking community, the rural small businesses that try to get loans from these now taken over banks and can no longer access even a SBA type loan.

I have numerous instances where we have a client and a small bank, an affiliate of a larger bank that will do a loan with SBA. But when it is referred up to the mother bank, it is denied. They

do not want to be bothered with that industry or to take construction loans at this time.

Just to give you an idea of the magnitude of what is going on nationally; in a normal recovery period, normal loan bank growth is in the 7 to 8 percent range. Today's lending growth is less than 3 percent; 1 percent of growth is $85 billion. If we just had 2 or 3 points percentage growth in bank lending, that would amount to close to $400 billion.

Now, if the stimulus bill could create 200,000 jobs with $16 billion, what would happen with $400 billion? Millions of jobs. There are millions of jobs at stake here.

What can we do about it? Velda Sue is certainly a long-term solution. There needs to be a structural reexamination of lending in this country. Banks, no matter what regulatory changes are enacted to reduce paperwork or whatever, are not going to be in the long-term capital needs for small business.

There has to be another vehicle or entity to help out in that situation. Access to a secondary market, which has facilitated the growth of the housing industry into a multitrillion industry, is essential in the long-term structural lending needs. However, the immediate need is to address the incentives to get banks back into lending. One way is to limit the use of funds to purchase Treasuries.

One individual mentioned NationsBank. They were recently noted as having over 20 percent of their assets in medium- to short-term Treasury securities. That amounted to, I think as I recall, around $80 billion tied up in securities. Why not? No risk, you are making 3 points, and no capital to set aside. It is a pretty easy decision to make.

The other thing would be to address some of the regulatory problems in the necessity to document virtually everything for no matter what size of loan. Most of the lending needs of small businesses are less than $100,000. Often the requirements for paperwork are the same even if it were $1 million.

I have been involved in SBA lending for over 12 years. In 1980, loan applications would weigh approximately a pound. Today we are up to over 3½ pounds in weight from application to closing.

Now, if we had not had the Federal Paperwork Reduction Act, we probably would not have a tree left in the country. It is a serious problem though, particularly for smaller loans. There needs to be some relaxation for smaller loans.

Mr. POSHARD. John, thank you for your testimony.

Let me just take a minute and talk about how this larger bank issue manifested itself in my district. Then I want to ask you how you see this working out.

Part of what a community goes for with regard to job creation are those medium-sized industries of 400 or 500 people. I represent a large rural district in Illinois. In that rural area, it was very difficult for us to get a small community bank to put forth the capital to help some industrialist who wanted to come in and locate a 300- or 400-person industry.

We could not get the banks for legal and other reasons to pool resources. So, we just did not have the capital base to fund those kinds of industries that every community is going out after.

There was a great effort made to convince everybody that what we needed to do was bring in branch banking from the First National Bank of Boston, and Chicago, and every place else, because they would have the capital to fund those industries.

Now, since this has begun, in the communities that you represent, do you see those larger banks that have come into the communities financing those kinds of medium-sized industries of 300, 400, or 500 jobs locating in your communities? Is there any evidence that they are doing that, because that was the single greatest reason given for the need to put more capital in the local communities?

Dr. McKee, you had your hand up.

Dr. McKee. I just said no; I have not seen any evidence.

Mr. Poshard. You do not see that happening?

Dr. McKee. No.

Mr. Poshard. Mr. Fedor.

Mr. Fedor. Mr. Chairman, I just had what I thought was kind of a strange experience. I worked so hard to work my way out of this cash-flow problem, and I finally got my bank paid off to zero. I am going out of town, and I am looking at other banks to see if I could get financing. When I turned over my paperwork to them, they said, "Well, you really do not require enough money for us to bother to come in and serve you." I mean this blew my mind.

One other comment I would like to make. That is that many of the manufacturers are getting into export sales. Here again, I think that we have to somehow deal with lending for work in process to manufacturing exports, which are very important to our country for our balance of payments. Working through the Eximbank for small companies, you can just forget it. I mean they may as well be on Mars.

Mr. Poshard. Thank you, Mr. Fedor.

Our last witness is Mr. Timothy Cowling, vice president of corporate finance for J.E. Liss & Co., Inc. in Milwaukee, Wisconsin.

TESTIMONY OF TIMOTHY M. COWLING, VICE PRESIDENT OF CORPORATE FINANCE, J.E. LISS & CO., INC., MILWAUKEE, WI

Mr. Cowling. Thank you. I appreciate the opportunity to share what I think is a very special perspective that I do not think that the other witnesses have, and which I think is still very important.

For more than 12 years, I made my living as a licensed securities investment broker and certified financial planner. In 1985, I purchased a small commercial printing operation and found a real career love in small business.

In 1990, I substantially reduced my retail investment brokering to concentrate on small business development. Since then, I have worked with dozens of fast-growing, mostly early-stage, private companies, and now have a personal interest in six of them.

My original plan was to acquire or start small businesses and help others do likewise. But, for the most part, I failed for lack of access to capital. About the only thing that went as expected was that my personal income dropped substantially, although not as much as Erskine Bowles. The new SBA Chief said yesterday that in

his first year of doing something similar as I am trying to do, his revenues, not his profits, but his revenues were $5,000.

Today, I work for J.E. Liss & Co., using both my small business and securities experience and licenses to help small, private, fast-growing companies to raise capital. We usually do so through $500,000 to $1 million private placements of debt or equity to individual and small retirement accounts.

I am here to tell you that in small business, especially the fastest growing small businesses, we are not dealing with just a credit crunch, but we are dealing with a capital crunch on both the equity and debt side. This capital crunch has been caused by a chain reaction in capital markets.

A simplified but still accurate description of this capital crunch is that those who were doing asset-based, prime fixed loans are out of the market. Those who were doing second-tier, higher yield loans moved up. Those who were doing bridge financing moved up. Those who were doing debt/equity deals moved into straight debt. Those who were doing second-stage equity moved into bridge. The people who were doing first-stage equity said we do not have to be here anymore, we can go second stage, or even up to bridge. So, now we have a gap, an absolute gap caused by this chain reaction.

This capital crunch causes the worst hurt among that sector of our economy which has created the most jobs over the past decade, and which could create even more. Small businesses of under $10 million of capitalization. These are companies that have gone beyond F&F financing known as family and friends, family and fools, or whatever derivation you would like to use.

But these are companies that have not reached the other end of the Valley of Death that fast-growing companies go through. I point out that this valley is illustrated beautifully in a Department of Energy book on business development.

The other side of this Valley of Death is where public markets, institutional markets, and yes, even banks await with capital. These are companies without substantial, hard assets in business sectors such as product or system design and distribution, or computer software, where we are world leaders and where large positive balances of international trade occur regularly.

These are companies creating information and service oriented jobs that pay well and offer opportunities for advancement. These are companies whose only chance to obtain true debt capital, that is debt that is not really equity and debt that has a good chance of being repaid, lies in their ability to raise early stage equity capital from outside sources unknown to them. This means that they must expend limited resources to slug through an expensive morass of rules and regulations.

I have three real life war stories. Example one, Innovative Control Systems. It makes detection, identification, and security systems for nursing homes, hospitals, and increasingly for a wider range of commercial clients. Sales in the last 4 years have gone from $300,000 to $2.5 million, from losses to profitability with a commensurate increase in employment. These are not minimum wage jobs.

Late last year, it had hundreds of thousands of dollars of purchase orders from hospitals in good financial condition, but could

not borrow funds to finance these purchase orders. It was forced to sell part of the company in a private placement to handle these orders.

Example two, Event Technologies. It has created software programs for the $11-billion-per-year industrial computer and control market. Electronic Data Systems has tested this software extensively. Its tests show that each year this software could save manufacturers billions of dollars in systems acquisition costs, and even more profit in engineering expenses.

The company has begun to do business with the likes of Allen Bradley, Amoco, and Philip Morris, but has not been able to get the $1 million that it needs to really push forward.

Example three involves two companies, Member Advantage Service Corp., serving credit unions, and another company which needs to go unnamed. In each case, the firms filed what are known as Reg. D private placements. A year ago, a Member Advantage representative mentioned the placement to a group of experienced venture investors in a technical but no-harm violation of Reg. D rules.

The heavy-handedness of the enforcement of the violation caused my firm to expend many hundreds of hours to repair what was a one-paragraph insertion in a 60-page placement document.

The second unnamed company, with an energy-saving device that the largest tire manufacturer in the world has endorsed, recently made the same mistake. So, we are unable to raise capital for them until they correct it.

Specifically, addressing Velda Sue, I would very much support the concept, for several reasons. First, the chain reaction that I talked about could be reversed. We could see the money start coming back the other way. Second, there is a vast and very fastly increasing pile of money coming into both personal accounts and retirement accounts as our population ages.

This money is looking for a good place to land. The securities industry's response has been to come up with derivational products in which you rip out interest from principal, criss and cross pieces of debt, and take 12-percent mortgages, and somehow get a 15-percent yield or do options on currency rates or something else that crashes people's money.

Velda Sue, I think, would offer a productive alternative. So, I support it in that regard. I would also suggest to you that there are two examples of somebody who has done something similar. One is a company by the name of Bando McGlocklin Capital Corp., an SBIC in Milwaukee, which over the last 13 years has operated an asset-based, lending portfolio which today is closing in on $100 million. In 13 years, it has never had a default.

A second example is a company by the name of St. Louis Leasing. We helped them create an off-balance sheet source of debt financing—which has allowed the company to grow from $12 million in sales 4 years ago to $75 million this year—in a very similar way of taking its business and putting it to markets for investors to purchase.

So, I call these examples to your attention. I would also like to call your attention to the fact that there are demographics today that I think are very overwhelming. We have a larger number of

women and minorities coming into business. We have a larger number of retirees who want to stay in business. We have the largest portion of the population entering that age when they are most likely to start businesses.

We have all kinds of other impacts. You were talking about interest rates. To answer your question on interest rates, it is not where they are, but the relationship between long- and short-term interest rates. We have the largest spread ever between long-term and short-term interest rates. Combine that with the insensitivity that small business people have regarding what they would pay on money if they could get it, and you have a tremendous opportunity for lenders to create very profitable spreads that should increase the availability of money.

So, I call these to your attention, as well as one other fact. We now have a lowering of the thresholds in order to get to the other end of that Valley of Death, in order to get to the IPO market. We have had several factors which, for the sake of brevity, I will not go into, which have reduced to one-third or one-quarter the threshold that a company needs to reach to access these markets.

But we cannot get there if we cannot get started from here. So, it is crucial that we deal with equity capital and keep in mind that equity capital is part of mosaic of financing for small business. Thank you.

Mr. POSHARD. Mr. Cowling, thank you for your testimony. I appreciate it. We may be submitting some questions to you for further answer, especially with regard to the availability of capital, which is an important part of this whole consideration.

Folks, I have to be at another meeting in 5 minutes. I want to thank you very much for your participation and your contribution here. This was a very worthwhile meeting. You have certainly given us a lot of suggestions that we can use in fashioning any further legislation that helps this credit crunch problem.

Thank you very much for being here. The committee is adjourned.

[Whereupon, at 11:56 a.m., the committee was adjourned, subject to the call of the Chair.]

APPENDIX

JOHN J. LaFALCE, New York
Chairman

JAN MEYERS, Kansas

Congress of the United States
House of Representatives
103d Congress
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6315

February 1, 1993

NOTICE OF COMMITTEE HEARING

TO: MEMBERS, COMMITTEE ON SMALL BUSINESS

FROM: JOHN J. LaFALCE, CHAIRMAN

RE: HEARING ON H.R. 660, THE SMALL BUSINESS CREDIT AVAILABILITY ACT OF 1993

Thursday, February 4, 1993, 9:30 a.m., 2359 Rayburn Bldg.

The Committee on Small Business will conduct a hearing on **Thursday, February 4**, on H.R. 660, the Small Business Credit Availability Act of 1993. The hearing will begin at 9:30 a.m.

H.R. 660 would create a Federally-chartered corporation to help make long-term, fixed rate loans to small businesses as a way of boosting economic development. The corporation, a government-sponsored enterprise (GSE), would create a secondary market to match up small business borrowers with large institutional investors such as insurance companies and pension funds.

The GSE, known as the Venture Enhancement and Loan Development Administration for Smaller Undercapitalized Enterprises (Velda Sue), would sell stock to raise private capital. This is similar to other GSE's such as Fannie Mae, a private corporation to support loans for homeownership. This new mechanism would be a supplement--not a competitor--to the current SBA programs.

Witnesses invited to testify are:

Howard S. Altarescu, Vice President
Mortgage Securities Department
Goldman, Sachs & Co.

Federick O. Terrell, Managing Director
The First Boston Corporation

James P. Murphy, Executive Vice President
Fleet Financial Group, Inc.

William Gossett, President
Liberty National Bank of Longwood (Florida)
representing **Independent Bankers Association of America**

SUMMARY OF

H.R. 660

"Small Business Credit Availability Act of 1993"
(VELDA SUE)

The legislation would establish a federally chartered but privately owned corporation called the Venture Enhancement and Loan Development Administration for Smaller Undercapitalized Enterprises (Velda Sue) which would do for small business what Fannie Mae does for housing.

Private lending institutions are basically short-term lenders and are unable to make long-term commitments, and in some cases simply do not have the available capital to make loans to small businesses or in the case of smaller banks have loan limitations which limit loan size. As a result, small business credit needs are going unmet in the private sector. This bill basically would bring together small businesses and their long term credit needs with institutional investors who have funds which could satisfy this need.

The Corporation would be operated by a permanent Board of Directors of 9 members (five being elected by the shareholders and four being appointed by the President). Stock in Velda Sue would be purchased by financial institutions which would seek capital from Velda Sue, and by other investors.

A minimum of $30 million in stock sales would be required before Velda Sue could commence business.

In order to help "make a market" for these loans, the Federal government would provide temporary capital to Velda Sue. The amount would be based upon the ratio of private capital to government capital ($1 to $10) and would be repaid by Velda Sue. In addition, the government would receive warrants to purchase non-voting Velda Sue stock at original-issue type prices, thereby providing for an upside for the Government as Velda Sue becomes profitable.

For purposes of eligibility to obtain financings, a small business would be defined as one which, in addition to being independently owned and operated and not dominant in its field of operations, qualifies under SBA loan standards or which has a net worth of $18 million or less, and annual net, after-tax income of $6 million or less.

Velda Sue would create a secondary market for small business loans either by purchasing the underlying paper and packaging it in pools and issuing its own securities backed by these pools, or by guaranteeing securities issued by loan poolers, provided it is backed by these loans. This paper would be sold to institutional

private investors such as pension funds probably at an interest rate of less than 1 point more than that paid by the U.S. Treasury.

Velda Sue would develop uniform standards for the loans. In order to establish a market and to promote quality loans, the Board would specify minimum standards for them which would include: a maximum principal amount; a maximum term not to exceed 30 years in the case of land or facilities and 10 years in the case of equipment; a requirement that the loan be fully amortized; a requirement that the loan not be in excess of 90% of the value of the asset; and a requirement that the loan be secured by a first mortgage position on the collateral.

If these conditions were met, the Corporation could buy 80% of the loan with the originating lender retaining 20%.

In addition, the Secretary of the Treasury would be authorized and directed to supervise the financial safety and soundness of Velda Sue. In essence, he would regulate its operations.

Any paper issued by Velda Sue or guaranteed by it would not be federally guaranteed, although its issuance would be subject to the approval of the Secretary of the Treasury. In addition, in his discretion and subject to the appropriation of funds, the Secretary of the Treasury, as a backstop, would be authorized to purchase up to $1.5 billion in Velda Sue paper, i.e., if Velda Sue needed additional federal money, the government might provide it if the need was justified.

The Corporation would be designed to be self supporting and would be required to establish a reserve to pay any losses it might sustain. These reserves would be funded by the imposition of guarantee fees not to exceed 2% of any loan guaranteed, and 1/2 of 1% of any security representing a pool of these loans.

Finally, Velda Sue would be prohibited by statute from incurring more obligations than an amount equal to 30 times the amount of its capital.

STATEMENT OF U.S. REP. JAN MEYERS
COMMITTEE ON SMALL BUSINESS
HEARING ON H.R. 660
FEBRUARY 4, 1993

Mr. Chairman,

I am glad we are meeting to get some insight into the credit problems facing small businesses. It goes without saying that the current credit squeeze is stifling small business growth and job creation and it is imperative that we act to correct this problem.

Today we will discuss the creation of a Government sponsored enterprise called Velda Sue. This corporation would establish and guarantee a market for securities based on small business loans. It would initially be funded by 30 million dollars in stock and a 300 million dollar loan from the Federal Treasury. Velda Sue would also have the implied guarantee of a 1.5 billion dollar bailout if it ever gets into trouble.

Mr. Chairman, I support the idea of easing credit for small business because I know that small business is the foundation of our economy and that small business growth means job growth. However, at a time when the federal deficit is growing unchecked I can not see the 300 million dollar creation of a government sponsored enterprise that carries the implied risk of a one and half billion dollar taxpayer bailout.

I think we would be better served to examine what is preventing banks and venture capital funds from lending to small businesses right now. Is the banking industry overregulated ? What can we do to encourage investment in small business ? Is the dramatic increase in applications to the SBA's guaranteed loan programs a sign that banks have the money to lend, but are afraid to without a guarantee ? I think we need to have answers, real answers, to the problems in the lending community.

With that in mind, I am glad to welcome our witnesses who represent some of the major forces on Wall Street and the banking community. I look forward to their insights on the small business community's credit problems and their own problems from the lending side.

Opening Statement of the
Honorable James H. Bilbray
February 4, 1993

Mr. Chairman. It is certainly obvious to those of us who have worked to help small business, that there is a desperate need for small business capitalization and financial assistance. This necessity compounded by the already taxed resources of the Small Business Administration lending programs has left a desperate need for assistance and new solutions.

HR 660 provides a creative opportunity to provide new sources of capital formation and financial assistance. Last years SBIC legislation provide a first step in providing new resources. Hr 660 and its Velda Sue program provide the next logical step. Building on the model of other federally chartered programs such as Sallie Mae, Velda Sue will provide a vehicle to bring the vast financial resources of pension funds, insurance companies and other investors together to the benefit of small businesspeople and without spending taxpayer's money.

Instead of continuing to propose supplemental after supplemental and shoring up the resources of the SBA, we need to provide creative, private sector solutions to the needs of small business. This program is not meant to compete with the SBA, but to complement and assist.

The Clinton Administration has already expressed a strong

commitment to assisting America's small businesses. It is Congress's responsibility to provide the Administration with creative solutions that will assist them with their goals. Velda Sue is just such as a proposal. I encourage my fellow colleagues to join me in supporting the Chairman's proposal and in assisting America's small businesses.

Lucille Roybal-Allard

SMALL BUSINESS COMMITTEE
H.R. 660, The Small Business Credit Availability Act of 1993
February 4, 1993
2359 RHOB

OPENING STATEMENT

I want to congratulate the Chairman for holding this hearing which is so important to the thousands of small businesses in my district. Just last week, we held hearings in the Banking Committee concerning the credit crunch which is hindering so many small entrepreneurs across our country.

My district includes some of the nation's largest financial institutions in the downtown business district as well as small cities which are some of the poorest communities in Los Angeles County. In these small cities, economic opportunity is often quite limited, but there are many small "Mom and Pop" neighborhood stores and family run restaurants. These are precisely the kinds of businesses that find it nearly impossible to obtain credit from commercial banks.

As a cosponsor of the Small Business Credit Availability Act, I look forward to hearing today's witnesses and working to improve the availability of credit to small businesses that will fuel job growth not just in Los Angeles but around the nation.

**STATEMENT FOR HEARINGS ON H.R. 660 -
THE SMALL BUSINESS CREDIT AVAILABILITY ACT OF 1993
THE HONORABLE MARJORIE MARGOLIES-MEZVINSKY
FEBRUARY 4, 1993**

Thank you Mr. Chairman for holding these most important hearings on H.R. 660, the Small Business Credit Availability Act of 1993.

I welcome the opportunity today to discuss and to learn about increasing the opportunities for small business owners to access much needed capital. Small businesses represent the majority of businesses in this country and in my home state of Pennsylvania, 92.7% of all businesses are classified as "small."

As we all know, much of the past economic growth in this country has been due to the efforts of small businesses. In Pennsylvania this fact could not be more true. From 1988 to 1990, small businesses created 100.0% of the net new jobs in the state. Certainly if we are to grow our nation out of this current recession, we must rely on the tremendous potential of our small businesses.

But the tightening of the money supply has made it more difficult for small businesses to obtain credit. Consequently, we are denying these companies the very capital they need to stimulate economic growth. I believe that H.R. 660 would help small businesses have access to credit, would help stimulate growth and will create jobs -- if we can be assured that Velda Sue's liquidity is guaranteed and its loan standards are high and strict.

However, we must also make sure that women who own their own businesses have access to these same credit pools. The 1992 State of Small Business Report, commissioned by the Bush Administration, reported that women-owned firms now comprise one-third (1/3) of all the firms in the United States. In Pennsylvania, the number of women-owned small businesses increased by 57.7% from 1982 to 1987, creating annual receipts of almost $13.3 billion. Today in the greater-Philadelphia area there are estimated to be approximately 100,000 women-owned businesses.

On Monday, I met with a woman, Caren Yusem, who helps run a Philadelphia-based organization, Compass Rose, which offers education, support, and most importantly, financing to women business owners. Compass Rose has extensive documentation proving that women are better credit risks, and default on loans less often than do men. Yet women continue to have a more difficult time obtaining needed capital and attracting institutional investors.

To cite an example of this problem, Ms. Yusem told me about two former bank vice-presidents who run a profitable auditing company just outside my district in Wayne, Pennsylvania. Their business has $400,000 in annual sales and $120,000 in annual net income -- a 30% margin! Despite their experience and their proven business ability, they were turned down by some local banks when they applied for an expansion capital loan; the best they could get was a home equity line. The problem? These successful people also happened to be women.

In short, I am very concerned about the ability of women who own businesses to access needed credit and am interested in learning how H.R. 660 would address this enormous problem.

**QUESTION FOR HEARINGS ON H.R. 660-
THE SMALL BUSINESS CREDIT AVAILABILITY ACT OF 1993
THE HONORABLE MARJORIE MARGOLIES-MEZVINSKY
FEBRUARY 4, 1993**

Studies done by Compass Rose, an organization based outside of Philadelphia, Pennsylvania, which offers education, support and financing to women business owners indicates that women have better credit ratings and a lower loan default rate than men, yet still have a more difficult time attracting institutional investors and obtaining much needed capital. Therefore, my question this morning is, very simply, how would H.R. 660 open up credit markets to women-owned businesses and improve their abilities to obtain financing?

STATEMENT BY CONGRESSMAN JOHN CONYERS, JR

SMALL BUSINESS COMMITTEE

HEARING ON H.R. 660

"SMALL BUSINESS CREDIT AVAILABILITY ACT OF 1993"

February 4, 1993

Mr. Chairman. I want to applaud you for holding this hearing. I agree that the problem of availability of financing for small businesses is one of the major impediments to economic growth in this country.

If enacted, the legislation which you have introduced and is the subject of this hearing, would be a highly important tool in providing capital for small business.

Access to credit markets, through federally supported secondary market facilities, has been one of the major forces behind the availability of credit for housing in this country. Small business is just as important and deserves the same level of federal support.

Providing a secondary market facility would encourage banks and other institutional lenders to lend to small businesses, and it would also provide liquidity, thus enabling lending institutions to free up money for more loans.

One of the major reasons that a secondary market for small business loans has not developed is the non-standard form of the credit instruments. Developing standardized instruments as well as creating a secondary market is one of the features of the proposed legislation.

Small business is the engine which drives the American economy. In addition to providing economic benefits for the business owners themselves, small businesses are also the largest job generator of any sector of our economy. According to the 1992 Report on the State of Small Business, from 1988 to 1990, small business actually created 100% of the new jobs in the U.S., while large businesses lost jobs. Specifically, 3,165,694 new jobs were created by small businesses, while large businesses lost 501,382 jobs. Almost 40% of U.S. Gross Domestic Product (GDP) is created by small business.

In addition to its importance to the economy, generation of small business is integral to any successful community improvement effort. Not only does providing entreprenurial opportunity to individuals help them to realize the American Dream -- in concert with job training, remedial education, other other social programs, it is the building block of neighborhood revitalization.

I am looking forward to the testimony from the distinguished panel of witnesses and to working with you, Mr. Chairman, in moving this vital legislation forward. I am pleased to be a co-sponsor of H.R. 660 and look forward to working with you in this important effort.

TESTIMONY

of

WILLIAM GOSSETT

PRESIDENT
LIBERTY NATIONAL BANK
LONGWOOD, FLORIDA

on behalf of

THE INDEPENDENT BANKERS ASSOCIATION OF AMERICA

regarding

"H.R. 660: SMALL BUSINESS
CREDIT AVAILABILITY ACT OF 1993"

before the

COMMITTEE ON SMALL BUSINESS

of the

U.S. HOUSE OF REPRESENTATIVES

FEBRUARY 4, 1993

Mr. Chairman, my name is William Gossett and I am President of Liberty National Bank in Longwood, Florida. I also serve on the Bank Operations Committee of the Independent Bankers Association of America (IBAA).

I appreciate this opportunity to testify on your proposal to create a secondary market agency -- Velda Sue -- for small business loans. As an active small business lender I support any reasonable proposal to increase lending to small businesses. I am sure this committee has heard many times that we must look to small businesses to create jobs since large businesses of all kinds continue to lay off thousands of workers.

Before commenting on the current small business lending climate and the Velda Sue program, let me tell you something about my bank and our small business lending activities. Liberty National Bank was established just over 10 years ago and we hold approximately $34 million in assets. However, that understates the amount of lending that we generate. In addition to the loans we added to our portfolio last year, we originated $6.5 million in SBA-guaranteed loans which we sold into the secondary market. At year end December 31, 1992, we had another $5 million in loan participations sold to community banks in Illinois, Kentucky, Alabama and Florida. As you can see, my bank does not share the prevailing regulatory opinion that "loan" is a four-letter word to avoid. Demand for small business loans is strong in our market, but we do face serious impediments.

Regulatory Climate and SBA Underfunding

I realize that this hearing was not called to provide a forum for a banker such as myself to air grievances regarding industry regulators or shortcomings in the U.S. Small Business Administration program. However, it is my belief that Velda Sue loans will not be made in a vacuum, but rather will be subject to the same onerous regulatory, compliance and environmental concerns as other loans in our portfolio.

I also suggest that Velda Sue's acceptance and participation levels by borrowers, lenders and the financial markets will be quite similar to that of the SBA. This belief is the result of the inherent comparable nature of the small business loans made, or to be made, under the respective programs. For these reasons, I will relate my concerns as I believe these same factors will greatly impact the ability of Velda Sue to achieve your highly desirable goals of fueling our country's small business credit needs.

The current regulatory climate discourages small business lending. SBA programs, which otherwise might be a significant alternative, have been significantly underfunded. Congress should address these, and other problems, at the same time it is working to create Velda Sue.

The proposed new agency could provide vital support for a rapidly growing small business sector, but it would be only one element. Banks will continue to

make a large share of small business loans and hold them in their own portfolios. SBA must also be strong to support loans which need the shoulder of the 7(a) guarantee to overcome certain risks in an otherwise qualifying bank loan.

Federal Reserve Chairman Alan Greenspan has noted that character, or judgment, lending is being regulated out of the banking system. These loans may not meet the strictest paperwork requirements taught in examiner school, but they have been the staple of bank lending and local economic development for years. While these loans are very important, they cannot be made to conform to uniform standards imposed by a secondary market. In fact, it is the examiners' insistence that small business loans meet homogeneous standards that is driving them out of our banks.

We hear a lot of concern expressed regarding the impact of the "credit-crunch" on small businesses. I propose to you that many of the nation's banks are small businesses and we too are severely affected by the "credit-crunch". For each small business loan not made, a bank somewhere is deprived of a loan customer and an earning asset.

It is important that Congress take an active part in restoring prudent judgment lending. The regulators cannot do it alone. The 1989 savings and loan legislation and the 1991 banking law were Congressional attempts to micro-manage the bank regulatory agencies, which, in turn, have attempted to micro-manage banking. These attempts are all too often delegated to young inexperienced examiners with unbelievable powers...examiners that have never worked in the private sector much less having the benefit of first hand banking experience. The pendulum swung too far, and Congress gave it a large push. The agencies will need political support and direction to reverse it.

Recently, the banking industry united behind a carefully targeted agenda designed to increase small business lending through regulatory burden relief. In a letter to President Clinton, the industry urged him to support legislative and regulatory steps that would stimulate economic growth. A copy of that letter, along with attachments, is included with my testimony.

I note, Mr. Chairman, that you sent a similar letter to Mr. Clinton and understand that you have personally spoken with the President. We appreciate those efforts and hope that your colleagues will support our efforts to reduce the burden of regulations that is hindering job creation.

Overzealous regulation has led to an increased demand for SBA loans, and the SBA's improved performance has put it in a position to meet that demand. Unfortunately, repeated funding shortages have hindered SBA programs. As an example, at our bank some $2.5 million of SBA loans are today bottlenecked awaiting approval and closure as direct result of the SBA running out of funds on December 10, 1992. Nationwide, good loans that would lead directly to new jobs are delayed until SBA funding becomes available. This is backwards; the SBA

should be able to help the economy in troubled times, the economy shouldn't have to wait for arbitrary deadlines to pass.

A more reasonable regulatory climate, as well as some increased SBA funding, could bring supply and demand back into balance. A well-functioning Velda Sue program could also play a vital role.

Velda Sue's Loan Limit Problem

I understand that Velda Sue could fund loans that are larger than the typical SBA 7(a) loan or the small business loan that a bank may desire to hold in its portfolio. An originator would fund a Velda Sue loan initially and some time later sell it into the secondary market.

This is similar to the process lenders use to sell home mortgage loans through Fannie Mae or Freddie Mac. But from the community bank perspective there is a critical difference between a home mortgage loan and a Velda Sue loan. An individual home mortgage loan is much smaller than a bank's individual loan limit. A bank has no problem holding that loan for a short time, several weeks or months, before it can be sold.

A Velda Sue loan would be quite different simply because it could be larger than our loan limit. For example, our bank's current loan limit is $750,000 and as a matter of prudent banking, we will impose a house limit of $500,000 to limit exposure to a single borrowing entity. A typical Velda Sue loan for the construction of a manufacturing or distribution facility might be as large as $2,000,000. Under current lending limits our bank could not participate in the Velda Sue program. We could not make and hold the loan for the construction or interim period until Velda Sue purchases the 80% portion of the loan designated to go into the secondary market.

Finding a solution is important to the success of the program. Since it is geared to small business lending, we would not expect larger banks to be active participants as is generally the case with the existing SBA secondary market program. If community banks could not be active, unregulated finance companies would likely be the primary beneficiaries. Once again, an important banking market would be lost to non-bank competitors.

Other factors in support of structuring Velda Sue to encourage participation by community banks include:

- Community banks have readily available funds to invest in small business loans

- Community banks represent a nationwide distribution system that is already in place. Many banks are in smaller towns and communities

that do not have access to non-bank entities or major banking organizations

- Community banks have a vested interest in the economic viability of the small businesses located in their communities

- Community banks have the necessary resources and people to quickly disseminate information, assist with loan processing and to make the program a success

There are two general approaches to solving the legal lending limit and concentration of credit problem--making adjustments in Velda Sue or adjusting banking regulations. Velda Sue could be permitted to operate more like the SBA program, rather than like Fannie or Freddie. Under SBA, the guaranteed portion of the loan is excluded for purposes of calculating legal lending limits and so the loan limit issue never arises. Similarly, Velda Sue could issue forward commitments to fund loans that banks would make. This would only work if bank regulatory agencies agreed that such commitments would be sufficient to override individual lending limits.

Alternatively, Congress or the agencies could change lending limits to permit banks to fund Velda Sue loans for a reasonable time, so long as the portion of the loan to be retained by the lender does not exceed the bank's legal lending limit. This should be acceptable from a safety and soundness point of view as long as the bank had a clear intention to sell the loan into the secondary market and the loan meets the conditions of that market.

Whichever solution to this problem that you adopt, it is very important that it be acceptable to the bank regulatory agencies. Unless they agree, community banks will be unable to fully participate in Velda Sue.

Conclusion

The Velda Sue program could be an important element of an expanding economy, but loan-limit rules must be adjusted so that community banks will be able to become active participants. In addition, Congress and the bank regulatory agencies should review and adjust their current policies that are discouraging small business lending. Finally, Congress should fully fund SBA programs. They are working well, but lenders and borrowers are discouraged by funding delays.

Thank you for this opportunity to testify.

December 7, 1992

President-elect Bill Clinton
Governor
State of Arkansas
Governor's Office
State Capitol
Little Rock, AR 72201

Dear Mr. President-elect:

During your campaign you made clear that increasing economic growth and job creation would be your top priority. The undersigned associations, which represent the entire banking industry, share this priority. We are writing to recommend several steps supported by the entire banking industry that you can undertake in the first few weeks of your administration to promote the flow of credit to businesses and consumers, thereby enhancing job creation and economic growth.

First, we are enclosing specific, targeted recommendations designed to eliminate the unnecessary regulatory burdens and paperwork that impede economic growth. These proposals would remove barriers to new, job-creating bank lending and can be implemented without undermining public confidence in the safety and soundness of our industry. Several of these recommendations can be accomplished quickly by executive order or by regulation. Others will require legislative action, and we urge that they be included in the economic stimulus package you will present to Congress in January. All have a clear link to creating new jobs and have no adverse budgetary impact.

Second, it is critical that you promptly appoint highly qualified individuals who are knowledgeable about the industry to the Treasury Department and the financial regulatory agencies. They should be committed to implementing a more balanced approach to bank supervision and regulation. As you pointed out during the campaign, regulatory overreaction has stifled bank lending and postponed economic recovery.

Third, in addition to our other recommendations, we urge your support for proposals that have already made considerable progress in the Congress -- reform of bankruptcy laws and making clear that secured lenders who have caused no environmental damage will not be required to pay for environmental cleanups. Notably, bankruptcy reform legislation passed both the House and Senate in 1992 without a single dissenting vote. Also, legislation dealing with environmental liability, co-sponsored by a large majority of House members, has passed the Senate several times.

Banks are reluctant to lend to many businesses, particularly small businesses such as gasoline filling stations, dry cleaners, printers, and even farmers, which may use hazardous chemicals because of the fear that a bank's environmental liability could far exceed the amount of an outstanding loan. It is important for bankers to consider environmental factors in making their lending decisions, but owners and operators, rather than lenders which have not caused pollution, should be responsible for cleanup costs.

Similarly, bankruptcy filings have increased dramatically during the last several years. Many of these filings abuse the system and have resulted in increased bank losses. These losses have discouraged many bankers from lending to businesses where the risk of bankruptcy is relatively

President-elect Bill Clinton
December 7, 1992
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high. This reluctance to lend translates into the creation of fewer jobs. Bankruptcy abuses have also increased the cost of credit to both consumers and businesses, thereby reducing economic growth.

Fourth, we urge you to request the Congress to promptly meet its obligation to fully fund the Resolution Trust Corporation and the Savings Association Insurance Fund. This will help maintain public confidence in the financial system by honoring the Federal Government's commitment to depositors and help stabilize the nation's real estate markets.

Fifth, as bankers we are closely involved in local economic development and are very interested in your community development bank proposal. We are eager to work with you and your administration on proposals to increase economic activity in areas where it is especially needed.

We thank you for this chance to present our recommendations and would welcome the opportunity to discuss them with you. We look forward to working with you.

Sincerely,

W H Brandon

William H. Brandon, Jr., President
American Bankers Association
President & CEO
First National Bank of Phillips County
Helena, Arkansas

R. W. Hawkins

Robert W. Hawkins, President
Independent Bankers Association
of America
Chairman, Southern Commercial Bank
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Richard M. Rosenberg

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Association of Reserve City Bankers
Chairman and Chief Executive Officer
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Douglas K. Freeman, Chairman
Consumer Bankers Association
Chief Corporate Banking Executive
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Gerald J. Pittenger, Chairman
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JOB-CREATING REGULATORY RELIEF BY ADMINISTRATIVE ACTION

During the campaign, President-elect Clinton linked regulatory overkill with concerns about the availability of credit and its impact on economic growth. The regulatory burden needs to be addressed in many instances through legislation. But until then, the bank regulatory agencies should be encouraged to adopt a balanced and reasonable approach to regulations implementing current law. In particular, the bank regulatory agencies should be encouraged to develop regulatory standards which rely on banks' existing internal policies and procedures to the maximum extent possible.

Small business is the job-creating engine in the United States and regulatory overkill is adversely affecting small business lending. Looking towards eliminating regulatory overkill and micromanagement, President-elect Clinton can take the following actions quickly, by executive order and/or agency action, to increase banks' job-creating lending to consumers and business, particularly small business.

1. *RESTORE CHARACTER LENDING*

The banking business involves risk and judgment. Character lending requires a blend of risk assessment and character judgment by the bankers. However, this former staple of bank lending is being regulated out of existence. Federal Reserve Board Chairman Greenspan recently stated that the "most recent thrust of legislation, and the associated supervision, has eliminated the so-called character loans that had so dominated lending practices of a large number of banks to individuals and small business."

Regulatory mandates and practices attempt to replace banker judgment with ratios and formula lending. If this unfortunate goal is accomplished, this country will lose one of its most valuable assets -- banks that are willing to take some risk and make loans to creditworthy borrowers. The potential borrowers who will be most adversely affected are the small businesses that are the backbone of job creation in our economy.

Job-Creating Relief: President-elect Clinton should encourage regulators and examiners to recognize that banking involves calculated risks and that character loans do not warrant blanket criticism. Serving the credit and deposit needs of the variety of small businesses, the assortment of industries, and the diversity of consumer needs in this country requires a banking industry that is willing to take prudent risks without fear of excessive regulatory sanctions and penalties.

2. *RESTORE DUE PROCESS--CREATE AN APPEAL PROCESS*

Recent legislation has placed increased emphasis on penalizing institutions that violate <u>any</u> law or regulation. This threat of civil money penalties and other sanctions is forcing banks to be overly cautious, dampening their enthusiasm for lending. Examination results are used to levy significant money penalties or enforcement actions against officers and directors, even for technical infractions such as inadvertent addition errors on regulatory reports. Business and individual assets are being frozen without the benefits of due process protections. An enforcement action can result in an institution being closed early, having its growth restricted, dividends limited, and directors and officers dismissed -- all of which discourage banks from actively seeking new lending opportunities.

The agencies' current appeals process does not provide due process because appeals are directed to examiners' supervisors, not decision-makers who are clearly objective. This further exacerbates the environment of fear. Bankers are reluctant to make sound loans that might fail to meet technical requirements.

Job-Creating Relief: President-elect Clinton should request that the agencies create an appeals process conducted by objective, high-level decision-makers. The process should permit institutions to contest an examination finding or request a review of a regulatory determination without fear of retribution. It should also permit institutions to contest their capital classification under the prompt corrective action rules. Creating an effective appeals process would send bankers a message that meaningful recourse is available if they disagree with an examiner's conclusions. This would encourage banks to be more aggressive in seeking new business and lending opportunities.

3. *RESTORE REASONABLENESS TO ACCOUNTING PRINCIPLES*

Current law permits the regulators to impose more stringent accounting rules on financial institutions than required by Generally Accepted Accounting Principles (GAAP). In some instances, the regulators are using this authority to impose Regulatory Accounting Practices (RAP) that further restrict credit. RAP place banks at a competitive disadvantage with other nonbank providers of credit. Differences between GAAP and RAP also add to banks' reporting burden, requiring different reports for the regulators and the public. Differences in the accounting treatment of loans sold with recourse hinder banks' ability to effectively utilize the secondary market and require unnecessary capital support, both of which serve to deter aggressive lending.

Job-Creating Relief: President-elect Clinton should discourage the regulators from deviating from Generally Accepted Accounting Principles (GAAP), particularly where the result further impedes banks' willingness to lend and places them at a competitive disadvantage with nonbank lenders. The agencies should be directed to eliminate the inconsistencies of RAP and conform with GAAP for loans sold with recourse in determining the amount of capital, which would be completely consistent with the principles of safety and soundness.

4. *ELIMINATE MARKET VALUE ACCOUNTING FOR BANKS*

The Securities and Exchange Commission (SEC) has been urging the Financial Accounting Standards Board (FASB) to require banks to apply market value accounting to the entire balance sheet. Market value accounting basically requires the valuation of an asset as if it were being sold today, regardless of the asset's maturity. A bank's primary business is to make illiquid commercial loans with the intent of holding them until maturity. Federal Reserve Chairman Greenspan noted that this is "the competitive reason for banks' existence and their special expertise."

Many commercial loans, particularly small business loans, lack ready markets that would enable a bank to "value" the loan as if it were selling the loan today. Chairman Greenspan said that "commercial loans generally do not fit into standard packages that are easily priced." This is because these loans are often made to unrated companies based upon the bank's credit judgment of the borrower's character, as well as the company's unaudited

financial statements. Chairman Greenspan also stated that "applying liquidating values to instruments not meant to be liquidated prior to maturity is a misapplication of accounting principles." The conclusion is that market value accounting is unworkable.

Market value accounting will decrease banks' willingness to lend. Current proposals already discourage banks from investing in local municipal bond issues, many of which are non-rated and have no ready markets. Market value accounting of debt and equity securities will cause significant earnings fluctuations and affect banks' capital levels. This volatility will further hinder lending.

Job-Creating Relief: President-elect Clinton should urge the SEC and FASB to recognize that market value accounting is not workable and will have a detrimental effect on banks' lending and the overall economy. The accounting agencies should adopt an accounting standard that recognizes that banks are special, that their job is to make illiquid investments in the form of loans to borrowers they judge to be creditworthy, and that market value accounting cannot be imposed on the banking industry without severe repercussions on banks' lending and the economy.

5. *MINIMIZE EXAMINATION DISRUPTION*

Agencies conduct examinations for safety and soundness, consumer compliance, trust, EDP, CRA and other purposes. Currently, only limited coordination is undertaken by the agencies to reduce the amount of time an institution must dedicate to examinations. As a result, banks can be forced to host examiners for weeks at a time, dedicating their staff to answering examiner questions and needs, rather than making loans or doing bank business.

Job-Creating Relief: President-elect Clinton should direct the Federal regulators to coordinate all bank examinations (e.g. safety and soundness, consumer compliance, CRA, EDP, and others) in order to minimize the disruptive effects of such examinations on bank operations, permitting banks to place greater focus on the business of banking -- lending.

6. *USE CAPITAL STANDARDS APPROPRIATELY*

Capital is an important indicator of a bank's financial health, but it is not the only factor that reflects a bank's financial condition. To fully assess the condition of a bank, the regulators have relied upon a rating system called "CAMEL," which evaluates banks for Capital, Asset quality, quality of Management, stability of Earnings, and Liquidity levels.

The FDIC Improvement Act requires the regulators to take "prompt correction action" against banks based solely on three capital levels. This means that, effective December 19, 1992, based only on where a bank falls in the five capital categories, it can be closed early, have its premiums increased, growth restricted, dividends limited, and directors and officers dismissed. Regulators have the added authority to lower, but never raise, a bank's capital ranking.

Relying solely on capital is not a prudent means by which to evaluate the industry. This focus on capital is forcing banks to raise higher and higher amounts of capital, and is discouraging lending. In addition, the reporting required to monitor compliance with the

rule is significant. Continuous fine-tuning of these capital standards poses an additional burden.

Job-Creating Relief: Banks meeting regulatory capital and other supervisory standards are penalized when regulatory standards designed for high-risk institutions are applied to all banks, low-risk and high-risk alike. This results in unnecessary costs for low-risk banks and a poor use of capital. The economy would be better served if the bank regulatory agencies were encouraged to provide banks meeting regulatory and other supervisory standards with lower costs through a reduced regulatory burden.

President-elect Clinton should direct the regulators to exercise their discretion to apply a more balanced approach to evaluating banks, relying more on the balanced "CAMEL" system and the similar "MACRO" system for savings institutions to the extent they can, rather than just capital. The regulators should also review the compliance burdens that these capital rules have placed on banks and reduce them where possible. The regulators should be directed to avoid repeated changes to the capital rules, including risk-based capital.

7. *PAPERWORK REDUCTION FOR CRA AND OTHER RULES*

The Community Reinvestment Act (CRA) and regulatory practices, such as requiring formal written policies for everything, are creating situations that foster documentation and paperwork and ignore performance. Regulators have been looking for banks to create big files and long policies to meet CRA requirements rather than looking at what banks are doing in their communities. Regulatory policy statements that focus on paperwork rather than actual lending programs are also a hindrance to lending.

Job-Creating Relief: President-elect Clinton should encourage the agencies to focus on what banks are actually doing to serve their communities, rather than documentation. The agencies should be discouraged from requiring expensive geographic and demographic analyses of lending and deposit activity, particularly in rural and small communities. Focusing on how a bank is meeting its community credit needs is a more productive answer to community reinvestment concerns than the current focus on paperwork and documentation.

8. *ELIMINATE DUPLICATIVE APPRAISAL REQUIREMENTS*

Examiners are requiring banks to create internal appraisal review processes and are often requiring banks to obtain second and even third appraisals for loans if they disagree with the current appraisal. This second guessing by examiners is greatly increasing borrowers' loan costs and is hampering banks' lending.

Job-Creating Relief: President-elect Clinton should discourage the regulators from requiring duplicative appraisals on loans that fail to raise a significant safety and soundness concern. This is an unnecessary impediment to bank lending and is hurting small business borrowers.

NEEDED LEGISLATIVE CHANGES TO BOOST ECONOMIC GROWTH IN LOCAL COMMUNITIES

The incoming Administration can propose a number of immediate legislative steps in its jobs initiative to provide the economic stimulus to banks to jump start our stagnant economy. By eliminating certain impediments to lending, significant amounts of additional capital will be freed up to lend to small businesses, consumers and others -- this creates jobs, promotes growth, and enhances public confidence in a speedy economic recovery which, in turn, acts as a catalyst to even greater economic growth. Moreover, reducing bank costs means lower cost to consumers, further encouraging economic expansion. Enacting these legislative changes will in no way jeopardize the safety and soundness of our Nation's banking institutions, and would represent an important "first step" towards long-term economic recovery.

The following targeted legislative steps have been identified by the banking industry at this time as provisions which should be included in the Clinton Administration's economic growth plan.

1. *Eliminate Supervisory Overreaction* -- Legislative responses to thrift industry problems (FIRREA in 1989) and its fallout for the banking industry (the Crime bill of 1990 and FDICIA in 1991) have imposed a formal and inflexible lending process. If this process is violated, lending officers, bank management and financial institutions could be subject to up to $1 million per day civil money penalties (12 U.S.C. 1818), as well as have their personal and business assets frozen (12 U.S.C. 1818(c)(1) and 1818(i)(4)). This has driven many qualified people from the industry and has prevented lending officers from making, and boards from approving, other-than-perfect loans for fear of retribution, thereby lessening the flow of credit to small businesses and others, limiting employment growth, and undermining local economies.

More flexible credit judgment needs to be restored to the lending process, allowing lenders to take more credit risks on borrowers. Current penalty provisions need to be modified to consider the size and the impact of the infraction when setting the appropriate penalty; maximum penalties need to be reduced. Due process protections need to be restored to ensure that personal and business assets cannot be frozen without adequate judicial review. Culpability standards should be reviewed to ensure that ordinary business judgements will not be subject to second-guessing and "hindsight" liability.

2. *Eliminate Micromanagement of Bank Operations* -- Bank regulation is best practiced on a case-by-case basis, tailoring supervisory intervention to the specific problems of the institution. This ensures the safe and sound operation of banks and promotes flexibility in the credit granting process so that banks can tailor their credit decisions to community needs. In such an environment, businesses flourish and jobs are created.

A legislative mandate in FDICIA (Section 132), however, requires Federal bank regulators in Washington to set nationwide standards for a wide variety of bank internal procedures, including a bank's internal controls, loan documentation practices, credit underwriting standards, interest rate risk exposure, asset growth, ratio of classified assets to capital, earnings, and stock valuation, regardless of whether these standards are appropriate for individual institutions. Congress has sent a clear message that Federal regulators should micromanage the affairs of our financial institutions.

This micromanagement operates as a "straitjacket" on bank operations. It limits bank flexibility in meeting community credit needs -- many small businesses fail to obtain credit and fewer jobs are created. Precious financial and human resources, which could otherwise be used for making loans, are tied up in unnecessary regulatory paperwork. The FDICIA provision should be repealed, thereby sending a useful signal to regulators to avoid micromanaging banks under existing laws and policies. Regulators would still retain the authority to stop unsafe and unsound practices at individual institutions, without the legislative mandate to intervene at every bank in the country.

3. *Increase Community Lending by CRA Incentives and Reduced Paperwork* -- The banking industry recognizes its important role in helping to meet the credit needs of local communities. However, the Community Reinvestment Act of 1977 (12 U.S.C. 2901 et seq.), which started out as a restatement of that responsibility, has evolved into a paperwork nightmare which diverts vital bank resources away from serving that function. The President-elect has already stated his concerns over CRA paperwork. Federal regulators should be legislatively directed to reduce CRA paperwork requirements and eliminate policies that effectively require the creation of "paper trails."

The incoming Administration should also explore whether other incentives may be created to help meet CRA objectives and encourage additional investment in our Nation's communities. For example, CRA should be amended so that banks will receive credit for investments in joint ventures that invest in communities outside local areas of bank operation. Moreover, safe harbors from challenges should be granted to banks with good CRA performances in order to reward good CRA efforts. The incoming Administration, working with industry groups and other interested parties, should explore whether other incentives may be created to spur additional CRA lending. Finally, the Administration should apply CRA statutory responsibilities on other types of institutions which are important sources of investment and lending capital.

Each of these suggestions will work towards revitalizing local communities and boosting economic expansion.

4. *Restore Reason to Accounting and Auditing Practices* -- Recent congressional action (Section 121 of FDICIA, which requires regulators to develop a method by which banks can supplementally disclose the fair market value of assets and liabilities) and regulatory debate by the Financial Accounting Standards Board (at the urging of the SEC) represents a movement towards imposing market value accounting on all bank assets and liabilities. Such a movement should be viewed with extreme caution because of its potential disastrous affects on credit availability. The bank trade associations strongly recommend against moving in this direction.

Forcing a bank to value investments and loans to current market value significantly decreases a bank's willingness to lend. For example, forcing banks to mark-to-market securities holdings will increase the volatility of bank earnings and capital levels, making it more difficult to match long-term assets with short-term liabilities, and discourages banks from providing long-term investments in their local communities. Similarly, applying market value accounting to bank loans also presents problems: because no secondary market exists for small business loans, any market valuations which take into account loan performance or the creditworthiness of bank borrowers would be very subjective and difficult to make. Market value accounting for these types of assets would be inappropriate and would seriously complicate a bank's ability to lend.

The recent legislative enactment (Section 121 of FDICIA), which moves towards market value accounting, should be repealed.

The incoming Administration should also consider eliminating unnecessary auditing costs, imposed by recent legislative enactments, which act as a brake on further economic recovery. Stringent new auditing requirements imposed upon independent auditors under FDICIA (Section 112) have transferred bank supervisory responsibilities to auditors, forcing them to assess a bank's compliance with safety and soundness regulations and subjecting them to significant liability for faulty judgments. This seriously drives up audit costs and creates incentives for auditors to eliminate risk from the credit-granting process. This artificially inhibits bank lending and delays economic recovery. Current auditor attestation requirements in Section 112 of FDICIA involving safety and soundness regulations should be repealed, with the responsibility for making such judgments left to Federal regulators. In this way, bank safety and soundness would not be jeopardized and an important impediment to bank lending would be removed.

The Administration should also recommend the repeal of provisions in Section 112 of FDICIA creating duplicative management report requirements and certain other restrictions on the makeup of internal bank audit committees. The former unnecessarily drives up bank and consumer costs; the latter forces certain directors off of bank audit committees, denying banks the benefit of the advice of competent individuals capable of accurately assessing the creditworthiness of potential borrowers. This, too, may impede the ability of banks to take sound risks and fuel a strong economic recovery. In order to

ease the impact of the remaining portions of the FDICIA provisions and provide for an orderly transition to the new rules, the Administration should also consider delaying the effective date of the remaining provisions.

5. *Eliminate Technical Impediments to Accepting Public Deposits* -- Current law (12 U.S.C. 1823(e)) may impose certain technical limitations on the ability of banks to provide public entities with adequate collateral to secure sizeable public deposits. As a result, many public entities are considering removing these deposits from local banks, depriving banks of important sources of funding used to finance economic development. Inappropriate limitations on the ability to provide adequate collateral should be removed.

6. *Modify Limits on Loans to Officers, Directors and Shareholders* -- Recent statutory changes (Section 306 of FDICIA) imposed new limitations on the ability of banks to meet the credit needs of bank officers, directors, shareholders, and related parties, potentially restricting the ability of banks to fund local economic development. Because many business leaders in communities serve on the boards of banks from whom they obtain their primary business credit, these statutory changes force banks to choose between lending to local businesses and retaining these qualified business leaders as bank officers and directors. Numerous banks will be faced with the dilemma of choosing between informed leadership and making job-creating loans.

The incoming Administration should consider the impact of these new loan limitations on financial institutions and provide limited additional flexibility to Federal regulators in providing exemptions to these rules. Regulators should rely upon the annual exam process and other supervisory tools to ensure that abuses in this area are uncovered, rather than impose blanket limitations on all banks.

7. *Better Understand the Impact That Bank Capital Standards Have on Credit Availability* -- Recent congressional actions have placed a strong emphasis on increasing bank capital levels as a means of cushioning against future credit risks and protecting Federal deposit insurance funds from loss. The banking industry strongly believes that financial institutions should possess adequate capital to cushion against loss. As such, it is generally supportive of congressional efforts to assure strong bank capital levels, such as through the implementation of the prompt corrective action sections of FDICIA, which impose a tiered approach to bank supervision.

However, the incoming Administration should consider the impact that changes in capital levels have on the availability of credit. Capital rules, if carried too far, can have the effect of diminishing a bank's ability and willingness to lend by tying up a significant amount of funds that could otherwise be leveraged into bank loans and by unintentionally creating a scheme of credit allocation. The Administration should closely review any further change to bank capital rules for its impact on credit availability.

Moreover, the Administration should consider three immediate changes to the capital standards contained in FDICIA (Sections 131 and 305) in order to increase the availability of credit to local communities:

(a) increase the flexibility of Federal regulators to consider "other appropriate factors" in determining an institution's capital classification. Under the current prompt corrective action provisions of FDICIA (Section 131), an institution's capital level is the primary factor in determining whether it will be subject to regulatory sanctions, including limits on growth. While capital is important, it should not be the only measure determining a bank's classification; other measures should also be considered where appropriate (including, but not limited to, such things as management expertise, earnings history, and asset quality). This will prevent otherwise healthy institutions from being subject to restrictions which reduce their ability to meet local credit needs.

(b) repeal the provisions in FDICIA that require bank regulatory agencies to develop capital standards to account for concentration risk and non-traditional activities risk (Section 305 of FDICIA). Standards in both cases will necessarily be arbitrary and potentially costly to banks, particularly for those already meeting existing regulatory capital standards. The bank regulatory agencies have adequate authority to deal with particular risks posed by engaging in unsafe and unsound banking practices, and both concentration risk and non-traditional activities risk are best addressed by the agencies under those existing authorities. In order to minimize the international competitiveness implications of U.S. capital rules, the Administration should also consider phasing-in the inclusion of interest rate risk in capital calculations (as required under Section 305 of FDICIA) to correspond to the implementation of similar international capital standards.

(c) create an effective regulatory appeals process to permit review of capital classifications under the prompt corrective action provisions (Section 131 of FDICIA). An institution's capital classification has a significant impact upon the ability of that institution to make independent credit decisions affecting local economic growth. These institutions should have the ability to appeal capital classifications to an independent source prior to becoming subject to regulatory sanctions.

8. ***Eliminate Anti-Growth Impediments in the Real Estate Appraisal Process*** -- Current statutory rules on the appraisal process increase consumer costs and place unnecessary impediments to economic development. The incoming Administration should closely review existing statutory rules on real estate appraisals to ensure that such impediments are minimized. For example, banks operating on state borders currently have problems using qualified appraisers licensed in one state but not the other. This delays loan processing and potentially drives up bank and customer appraisal costs. The Administration should consider legislative ways to alleviate this cross-border reciprocity problem.

9. *Minimize Credit Restraints in Bank Regulation* -- Regulatory examinations clearly represent an integral part of the supervisory process. However, certain aspects of both existing exam requirements and the new requirements of FDICIA will unnecessarily hinder the ability of well-run banks to operate efficiently to meet local credit needs.

Financial institutions are currently subject to a variety of examinations, often from both state and Federal sources, at different times of the year. These examinations represent a costly and serious intrusion into everyday bank operations, tying up bank management and other resources for weeks at a time, and keeping these resources from being used to promote further economic growth. Efforts should be made to increase regulatory flexibility in this area and minimize both the costs and the disruptive effects of the current exam process, while maintaining the integrity of the general process.

The incoming Administration should consider modifying current laws on examination requirements to: permit strong community banks to be examined every two years; allow state examinations to satisfy Federal examination requirements; and allow banks within a multibank holding company to be examined less frequently under certain limited conditions (which ensure that safety and soundness is maintained). These minimal changes will reduce bank costs and permit more time to be spent meeting local credit needs.

FIRST BOSTON

Testimony of Frederick O. Terrell

Managing Director, The First Boston Corporation

Before the

COMMITTEE ON SMALL BUSINESS

John J. LaFalce, Chairman

Hearing on H.R. 660

Small Business Credit Availability Act of 1993

February 4, 1993

Mr. Chairman and members of the Subcommittee, I congratulate you for holding this hearing examining the creation of Venture Enhancement and Loan Development Administration for Small Undercapitalized Enterprises (Velda Sue) and an enhanced environment for small business lending.

My name is Frederick O. Terrell and I am a Managing Director with The First Boston Corporation. I have been with the firm since 1983. First Boston is a full-service international investment banking firm serving both suppliers and users of capital around the world. Through its wholly owned subsidiaries -- The First Boston Corporation in the Americas, Financiere Credit Suisse-First Boston in Europe and the Middle East, and CS First Boston Pacific in the Asia/Pacific Region -- CS First Boston provides comprehensive financial advisory services and develops innovative financing approaches for a broad range of entities. The firm employs its own capital resources to trade and underwrite securities and to engage in merchant banking and other principal transactions.

In my current capacity I serve as co-head of the firm's Conventional Issuance and Trading Group which has responsibility for delivering mortgage and asset-related investment banking services to banks, thrifts, federal agencies and to other entities operating within the broad financial institutions arena. In this capacity special product emphasis is placed on securitization - the process of creating financial instruments from the pooling of assets with what are often very

dissimilar cash flows. It is an area for which First Boston has served as a pioneer - creating the first Collateralized Mortgage Obligation (CMO) for Freddie Mac in 1983 and the first Asset-Backed Security (ABS) for the then Sperry Lease Finance Corporation in 1985. During the last several years I have also had the responsibility of leading First Boston's government finance efforts as the firm became actively involved with the Federal Government's program to liquidate certain assets from the balance sheets of its agencies and departments. As an outgrowth of this effort First Boston currently serves as lead manager for the Department of Veteran Affairs Vendee Loan Securitization Program through which the mortgage market's first full faith and credit REMIC Certificates were issued last year. In 1988, First Boston was the sole manager for the $20 million initial public offering of Federal Agricultural Mortgage Corporation (Farmer Mac) stock. In 1991, First Boston placed the $65 million private equity portion of capital for the College Construction Loan Insurance Association or Connie Lee. Velda Sue, as currently contemplated, parallels some of the features and objectives included in these successful efforts with other agencies. Finally, among its wide variety of securitization activities within the federal agency sector, the firm currently acts a lead manager for two Small Business Administration (SBA) Securitization Programs, one on behalf of the Small Business Investment Companies (SBICs and SSBICs or MESBICs) and the other, the Section 504 Program, on behalf of Community Development Corporations (CDCs) across the country.

My comments today will be brief and will focus first on the critical role that liquidity plays in any secondary market place and then on two basic questions:

1. Will the securities market readily accept bonds which are backed by small business loans? and

2. Will the creation of Velda Sue promote small business lending?

LIQUIDITY IS AN ESSENTIAL ELEMENT OF A WELL FUNCTIONING CAPITAL MARKET.

Investors or purchasers in any market will evaluate the opportunity to invest capital using certain fundamental criteria. Foremost among these criteria is the desire to capture the greatest return for the lowest risk. This risk benefit analysis is performed hundreds of thousands of times a day as the skilled investor compares, in relative terms, the risk and reward characteristics associated with one instrument versus another. Such relative value analysis focuses on the price and yield of the securities offered and the inherent risks associated with cash flow, ie. prepayments, (the risk of receiving principal repayment unexpectedly – such prepayments are caused by refinancing, as we have witnessed in abundance during the last twelve months) or credit, ie. defaults, (which create similar prepayment implications for investors in mortgage backed securities).

Once a comfort level is reached by an investor, based on these fundamental criteria, he is prepared to purchase as long as he is satisfied that the opportunity exists for a timely exit or trade of the investment. In other words how liquid is it? To the extent that it is not an instrument which is actively traded and where opportunities for future disengagement are limited, the price will rise by what is commonly referred to as an incremental "liquidity premium".

The same analysis that exists in the secondary market is at play in the primary lending market as lenders, investors, first determine the interest rate to be charged in connection with a loan based on an assessment of risk and opportunity cost of loaned capital, but also rely on liquidity as an important safeguard of value. For lenders, liquidity in the form of an active secondary market can result in a more forgiving lending environment where borrower's needs can be met more easily and ultimately at a lower cost. This would appear to be the primary goal of Velda Sue.

WILL THE SECURITIES MARKET READILY ACCEPT BONDS WHICH ARE BACKED BY SMALL BUSINESS LOANS?

YES, A WIDE VARIETY OF ASSET TYPES HAVE BEEN USED IN SECURITIZATION PROGRAMS.

In relationship to the creation of Velda Sue, the good news is that ample capital exists in the mortgage market for a steady investment of Velda Sue securities, backed by pools of small business loans. In addition, recent SEC changes provide even greater flexibility in securitizing business loans through the more efficient shelf registration process.

Starting with the collateral itself, it is important to recognize that in the past several years the market for securities backed by a wide variety of assets has exploded. Beginning with lease-backed receivables in 1985, the types of asset receivables which have been securitized include receivables from boat loans, mobile homes, credit cards, automobile leases and many other asset types. Agricultural loans once thought to be too non-uniformed and unpredictable have found a home in the securitized marketplace with the advent of Farmer Mac. The RTC's massive non-agency securitization program has not only sold residential loans but hard to sell assets such as commercial loans and most recently non-performing commercial loans. These transactions were sold without the use of a federal guarantee as the RTC's program relies solely on credit support from the collateral itself. The Department of Veterans Affairs securitization program was developed around "loans to facilitate" the resale of prior VA loans which had previously defaulted. These loans particularly vulnerable to defaults, were originally viewed as inappropriate for securitization. To date, the VA has securitized almost $4 billion over a four year period.

The categories of assets for which there is an accessible market is virtually limitless at a price, and that price will be directly affected by credit quality and liquidity.

In 1992, $428 billion of asset and mortgage related securities were issued. The following is a breakout by category:

1992 Mortgage and Asset Backed Securities Issuance (1)

(In 000's)

Mortgage-Related	
Agency (GSE-backed CMO's)	$281,800,000
Non-Agency	95,900,000
Total Mortgage-Related Issuance	$377,700,000
Asset-Backed Receivables (Non-Mortgage)	
Home Equity	$ 6,000,000
Credit Card	15,800,000
Automobiles	19,600,000
Other	9,800,000
Total Asset-Backed Receivables	$ 51,200,000
1992 TOTAL MORTGAGE AND ASSET-BACKED SECURITIES	$428.9 billion

(1) Source: Investment Dealers Digest Data Base

In light of the success of this program and that of the 7a program in which an active market has developed in connection with guaranteed portions of these loans, and the development of the securitization market generally, I believe there is substantial evidence supporting the proposition that a market exists for small business loans.

As mentioned earlier, First Boston currently participates in two SBA programs which finance themselves, in part, through the capital markets - the SBIC program which supports venture capital investments and the Section 504 Development Companies Program. Both programs serve as examples of the markets' receptivity of SBA Guaranteed Debentures backed by SBA loans. With respect to the 504 program, approximately $40 million of 20-year securities are offered per month and $10 million of 10-year securities are offered quarterly by First Boston and Merrill Lynch & Co.. This financing program has been in existence since 1986 and has sold almost $2 billion of securities to date. Proceeds from the issuance of SBA Guaranteed Debentures are used to fund loans to small business concerns for the construction of physical plants machinery or equipment. As an underwriter for these transactions, I am pleased to report that investors have produced a consistent appetite for this product which appears at this point to have great depth.

WILL THE CREATION OF VELDA SUE PROMOTE SMALL BUSINESS LENDING?

AFTER AN INTRODUCTION PERIOD VELDA SUE SHOULD SERVE TO ENHANCE SMALL BUSINESS LENDING WITH ADDITIONAL LIQUIDITY AND WILL ACHIEVE ITS OBJECTIVES IF THE PROGRAM IS EASILY ACCESSIBLE TO POOLERS.

It is well established that the market places great confidence in the participation of the federal government. Undoubtedly, the receptivity of the current Section 504 Guaranteed Debentures is only partially attributable to the acceptance of small business loans as collateral. While investors are concerned with the performance of the small business borrower due to the impact of borrower behavior (prepayments and defaults) on cash flow certainty, investors in this program are primarily concerned with purchasing a stable, direct government guaranteed instrument at a yield greater than GNMA'S which have greater prepayment instability but are vastly more liquid. If placed under a Velda Sue format, Section 504 Development Company loans and other loans that are packaged under an indirect guaranteed umbrella, would attract a slightly different investor group and would bear a higher interest rate. (If the current Section 504 transactions were backed by a Velda Sue guarantee the yield in today's market for the 20-year debenture would be approximately 30 basis points higher.) This pricing disadvantage of Velda Sue securities in relationship to current SBA loan secondary markets could be offset by larger Velda Sue issuance sizes brought about by increased demand for loans. Such increased demand will in turn be stimulated by

the aggressive pricing of securities being passed on to poolers or lenders.

It should be understood, however, that the existence of GSE-sponsored secondary market alone will not produce a more active lending environment. Based on our reading of Velda Sue, its creation would not be inconsistent with the maintenance of existing fully guaranteed programs. In as much as potential Velda Sue Poolers may choose to pool loans of a higher credit quality to reduce losses, a sector of relatively weaker small businesses whose net worth is under $18 million may be without financing if the direct government guarantee programs were eliminated. Moreover, the retention of existing programs and Velda Sue might increase lending for larger small businesses and while providing an opportunity through stronger underwriting standards for more efficient and cost effective operation of existing guaranteed programs.

Finally, we are mindful of structural impediments which initially served to impede the progress of recent GSE experiences like Farmer Mac. It is important that Velda Sue take full advantage of lessons which have been learned in other settings particularly with respect to the existence, disposition of and other implications for first loss/subordinate classes. The incorporation of the opportunity for Velda Sue to be a direct purchaser of loan pools as is the case for Farmer Mac, is an example of a useful concept borrowed from other GSE's which will greatly assist the operation of Velda Sue.

In closing, I would like to stress that First Boston supports your efforts designed to enhance small business lending. Based on the many contributions made by the small business sector, no area in our economy is more important to promote. We look forward to working with this Committee and others to fashion an approach which is reflective of the true potential of a expanding marketplace and the role that suppliers of capital, its users and intermediaries can play in bolstering the small business community.

Thank you very much for the opportunity to speak to you.

STATEMENT OF

JAMES P. MURPHY

EXECUTIVE VICE PRESIDENT

FLEET FINANCIAL GROUP, INC.

BEFORE THE

COMMITTEE ON SMALL BUSINESS

UNITED STATES HOUSE OF REPRESENTATIVES

HEARING ON H.R. 660

THE SMALL BUSINESS CREDIT AVAILABILITY ACT OF 1993

February 4, 1993

Good morning, Mr. Chairman and Members of the Committee. My name is Jim Murphy, Executive Vice President of Fleet Financial Group. Fleet is headquartered in Rhode Island, and is the nation's 14th largest diversified financial services bank holding company with over $45 billion in assets. We have 1,300 offices in 42 states, and employ over 25,000 people in our seven banks and more than a dozen financial services companies.

I am happy to be with you here today, along with my distinguished colleagues on this panel, to talk about Chairman LaFalce's legislation to create a secondary market for small business loans known as the "Small Business Credit Availability Act of 1993" (H.R. 660).

Fleet's seven banks in New York, Massachusetts, Maine, New Hampshire, Connecticut and Rhode Island, and its non-bank financial services subsidiaries, are very active in lending to small and moderate sized businesses. In fact, together, our seven banks have over $1.6 billion in small business loans outstanding[1/] and our New York banks recently won an award from the Small Business Administration (SBA) for being the top lender among New York banks for the use of SBA loan programs in 1992, with over $29 million in SBA loans.

Most of our small business loans go to businesses with sales of $5 million or less, who usually borrow $500,000 or less. However, we also make bigger loans to much larger companies. Nevertheless, our current small business loan portfolio consists of a large number of small loans (average size of $55,000) across a wide-spectrum of industries and businesses that provide us with both industry and borrower diversification. Most of our portfolio is concentrated in the retail, manufacturing, construction, restaurant and service industries, as well as insurance and real estate lending.[2/]

Community banking units were established in 1992, in all of our banking subsidiaries, in order to more effectively serve the local small business market. This reorganization was successful in producing a sound and profitable loan portfolio, with consistent underwriting and standardized loan monitoring and management. Most of the loans in this portfolio would be well within the parameters of the Velda Sue program.

Clearly, we support initiatives designed to increase bank lending and credit availability, and are interested in doing everything possible to stimulate the economy in the Northeast, which has been in recession for the last several years. That is

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1/ <u>See</u> Appendix A.

2/ <u>See</u> Appendix B.

why we are intrigued by Chairman LaFalce's idea to put a secondary market in place for small business loans.

This program, especially if targeted to small businesses that are having trouble getting affordable sources of credit from traditional lending sources, could be particularly helpful in improving the economy by stimulating lending to innovative and growing companies that create jobs. This would not only help banks serve their communities better, but it would make them stronger by enabling them to sell the loans and, perhaps, reduce their risks.

A major problem with current small business lending is that each loan structure is individualized, and often dependent upon intangible qualities, such as the management skills of the potential borrower, along with pure financial data such as cash flows and the like. This means that small business loans are relatively illiquid and generally not securitized and sold in a secondary market. If something were done to increase the liquidity of these loans, it would make more capital available for small business lending.

H.R. 660 attempts to do this by creating a government sponsored enterprise (GSE), similar to Fannie Mae, to encourage the development of a secondary market for small business loans. As I understand it, the way this market would work is that a potential small business borrower would come to a bank and apply for a loan. The bank, which would serve as a primary distribution network for this program, would profile the loan against both its own underwriting standards, and those mandated by Velda Sue's Board for loans that would qualify for securitization. Qualifying loans would then be sold, either individually or as a pool to Velda Sue, or a private certified "loan pooler", to be packaged and sold as securities in the secondary market. The originator of the loans would retain the right to service those loans.

Fleet is active in small business lending and is always seeking to provide credit to those that meet our underwriting standards. However, if one takes the view, as the sponsors of this legislation apparently do, that the credit needs of small businesses are not being adequately met by the current system, the development of a secondary market for small business loans makes a great deal of sense. In theory, it would make more capital available for additional lending, especially to those borrowers that need extended-term loans at fixed rates -- which are often difficult to obtain in the current market.

For example, an existing customer of a bank, who is already being extended short-term credit, needs to buy real estate or heavy equipment to expand his business. Instead of expensive short-term credit, he wants the bank to give him a long-term, fixed-rate loan. The problem in the current system is that due

to the credit risk that would be retained by the bank (since there is no secondary market for this loan), it would be difficult to obtain such a loan from the lender. However, with the Velda Sue secondary market in place, the lender could provide the long-term fixed-rate loan and then sell it to Velda Sue, or a loan pooler.

As Carol Parry, Managing Director for Community Development at Chemical Bank, noted in her January 27, 1993 testimony before the Consumer Credit and Insurance Subcommittee of the House Banking Committee on behalf of the Consumer Bankers Association, the SBA's current 7A guarantee program is simply not flexible enough to help banks make small business loans in distressed communities. For example, it is nearly impossible to get an SBA guarantee on a "line-of-credit", which is the product most small businesses need the most. Velda Sue, through its guarantees, may provide an alternative to help with this problem.

The wild card in this, of course, is the price. The key question for potential borrowers will be whether market conditions will allow the bank to provide an acceptable, and competitive, interest rate to make these types of loans worthwhile.

To be successful, Velda Sue must be structured correctly and overcome a number of problems that have impeded the development of a secondary market for small commercial loans thus far. One critical issue that must be dealt with, which has already been identified in the legislation, is the development of uniform underwriting standards, the details of which are left to Velda Sue's permanent board.

For instance, right now, lenders and investors do not have confidence that they can predict the performance of commercial loans, particularly small business loans. Therefore, it is hard for them to determine what someone would be willing to pay for these loans. Predictability, and thus the ability to judge risk, would be enhanced by standardized underwriting.

This may be a difficult task. Commercial loans, in general, are not standardized because there is usually little basis for comparability between businesses. Variations exist in the appraisal of the value of one business compared to another. Also, comparing cash flows can be a major problem. All of this means that it is very hard to standardize the necessary documentation, and no one has been very successful so far in putting all of this together in the private sector.

The text of the legislation lists a number of minimum standards for such loans, including a maximum principal amount and term for the loan. Although these standards are helpful, they do not address all the issues that need to be thought through. Clearly, how well the Board does in establishing the

parameters of loans eligible to be pooled and securitized by Velda Sue, or the loan poolers, is critical. We suggest that these guidelines focus on establishing:

1. A predictable way to determine the probability of default.

2. A predictable way to determine the probable loss in event of default.

3. A way to standardize rates of return for investors.

4. A national rather than regional market.

5. A way to standardize ongoing loan monitoring and servicing. For example, parameters would be necessary to define "delinquency" and at what stage servicer intervention would be required.

Of course, bank and other insured depository institution participants in this system, must be assured that they will not be criticized by their regulators for applying the underwriting standards approved by Velda Sue.

There are a number of other issues that the Committee should consider as it reviews this legislation. For instance, although Velda Sue itself, and not the federal government, is the guarantor of the loans and underlying securities, there is still some risk for the government. For example, if it becomes necessary, the Secretary of Treasury could be authorized to purchase up to $1.5 billion in Velda Sue paper. While the absence of a federal guarantee does reduce the government's and taxpayers' risks, the Committee may want to consider whether a GSE-type structure is advisable, or even necessary.

Banks and other insured depository institutions are eligible to buy stock in Velda Sue. We support this idea, but one incentive the Committee may want to consider is providing Community Reinvestment Act "credits" for those institutions that do invest in Velda Sue.

Some thought should be given to the maximum terms set in the legislation for Velda Sue loans -- 30 years for land and 10 years for equipment. These terms may be too long for most banks because of the risks involved in holding loans for that length of time.

Another key determination that the Committee must make is whether a market exists for these types of loans, if and when they are standardized. Without the benefit of a government guarantee, investors would need to have a good grasp of the risks

involved, and pricing (which may be high) must reflect that risk. My assumption is that such a market does exist, but this issue is better addressed by my colleagues here today from Wall Street.

One additional aspect of the Velda Sue proposal which should be kept in mind is its potential usefulness in enabling banks to more readily respond to the credit needs of small businesses in low and moderate income communities and its potential positive impact generally for those communities.

The Community Reinvestment Act encourages banks to make sound loans within their communities, and in many cases, these could be eligible for the secondary market opportunities contemplated by the proposed legislation. Over time, as Velda Sue gains experience, more difficult credits might be handled through special supplemental programs for small business analogous to those targeted to the first time home buyer and related programs afforded by existing secondary mortgage market agencies, such as Fannie Mae and Freddie Mac.

In addition, the Clinton Administration is expected to make a proposal with respect to Community Development Banks in the very near term. This concept was the subject of hearings last week before the Subcommittee on Consumer Credit and Insurance of the House Committee on Banking, Finance and Urban Affairs.

I do not intend to go into detail on community development banks, except to say that Velda Sue could make programs currently supported by the banking industry, either directly or through community development corporations, more effective because of the outlet the legislation would create for their current loan portfolios.

In fact, Velda Sue could provide benefits to the entire network of federal (primarily through the Small Business Administration), state and local government, and community based community development programs, by making them more attractive as capital and credit generating vehicles. If a portion of the proposed $850 million to develop a new national community development trust were made available to jumpstart secondary market activity under Velda Sue, this result could be achieved more quickly than expected.

Conclusion

Mr. Chairman, Members of the Committee, I believe that the Velda Sue program, if properly structured, could help banks make more long-term, fixed-rate credit available to small businesses all across this country. Thank you for asking me to testify here today, and I hope that my comments, and those of my colleagues on this panel, will be helpful to you as you continue your work on H.R. 660. I look forward to answering any questions you might have.

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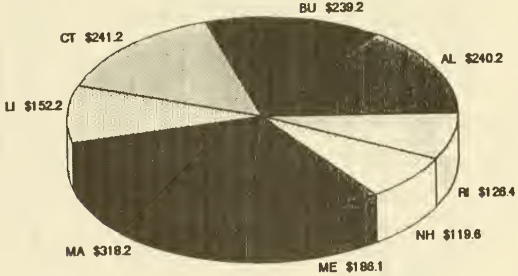
APPENDIX A

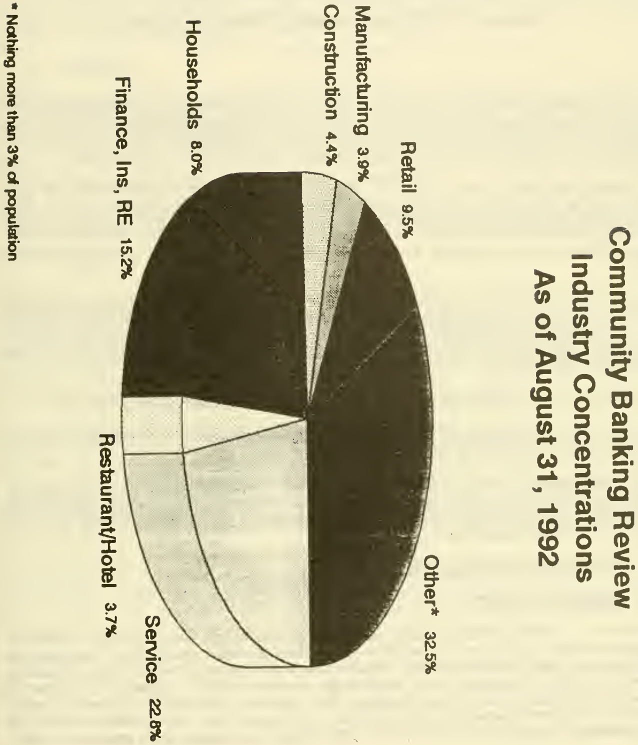
Community Banking Review
Bank Outstandings
As of August 31, 1992



	AL	BF	CT	LI	MA	ME	NH	RI	Total
Outstandings	240.2	239.2	241.2	152.2	318.2	186.1	119.6	126.4	1,623.1
% of Total	14.8	14.7	14.9	9.4	19.6	11.5	7.3	7.8	.100.0

(in millions)

APPENDIX B


Community Banking Review
Industry Concentrations
As of August 31, 1992
Other* 32.5%
Retail 9.5%
Manufacturing 3.9%
Construction 4.4%
Households 8.0%
Finance, Ins, RE 15.2%
Restaurant/Hotel 3.7%
Service 22.8%
* Nothing more than 3% of population

Testimony by Howard S. Altarescu
Goldman, Sachs & Co.

Congress of the United States, House of Representatives,
Committee on Small Business

H.R. 660, The Small Business Credit Availability Act of 1993

February 4, 1993

My name is Howard Altarescu. I am a Vice President of Goldman, Sachs & Co. and co-head of the Structured Finance Group in the Mortgage and Asset Backed Securities Department. Goldman Sachs is one of the lead investment bankers for the Small Business Administration's SBIC program and is a leading investment bank in the areas of mortgage and non-mortgage asset securitization.

The proposed legislation would, among other things, establish the Venture Enhancement and Loan Development Administration for Smaller Undercapitalized Enterprises (Velda Sue), which would be a corporation chartered by the federal government as a government sponsored enterprise (GSE). I have been asked to comment on the potential viability of the Corporation as well as the relative merits of the small business loan-backed securities to be issued by the Corporation, compared to securities of other GSEs.

There are a wide variety of GSEs as well as a wide variety of securities issued or guaranteed by such entities. The securities issued or guaranteed by these other GSEs range from common and preferred stock and corporate debt obligations to pass through trusts, collateralized mortgage obligations, so - called REMIC securities and stripped mortgage backed securities, including interest only (IO) and principal only (PO) securities.

The GNMA and SBA programs enjoy the full faith and credit of the United States government.

Sallie Mae, FNMA, FHLMC and Farmer Mac are corporate instrumentalities of the federal government but are privately owned corporations, each subject to government regulation.

Certain characteristics of selected GSE entities are shown in Appendix A. In many respects, the Corporation's structure is similar to other GSEs which have been successfully enabling private lenders to access the capital markets for funding with stability and certainty and without the full faith and credit guarantee of the federal government.

I. **Issues Regarding Viability of the Corporation**

Demand for "Product"

The lenders who testify later today will be better able to describe the extent to which demand by borrowers may exist for the type of loans which the proposed legislation would cover. These lenders will also be better able to describe whether the outlet to be available through the Corporation (including the level of guarantee fees) would be an attractive alternative to lenders, in comparison to (a) holding the loan on the lender's balance sheet; (b) selling 100% of the loan on its own or in a pool to another institution, on a servicing released basis; or (c) securitizing a pool of the loans without the benefit of the Corporation's guarantee or the other features afforded by the legislation, while retaining servicing.

The testimony of these lenders may then provide the basis for a business plan which would indicate a volume of business and related revenue for the Corporation, which then may be used to support an initial public offering. Initial public offerings are more usually based on actual historical operating experience and, perhaps, projections based on that experience and results. Such an offering would be more likely to succeed if a substantial book of business and an established operating track record were in place prior to the offering. Forward commitments or other arrangements to assure a revenue stream would also provide a degree of comfort. Evidence of sustainability of the business and strong management are also prerequisites to a successful equity offering.

User Stock

The proposed legislation provides that the Corporation may require originators and certified poolers to make capital contributions to the Corporation to meet administrative expenses and to contribute to the financial safety and soundness of the Corporation. Section 8 (b) (1). The lenders who testify will better be able to indicate whether lenders would be receptive to such a requirement of an open ended capital commitment. A better definition of this contingent exposure may be required for originators and poolers to evaluate the economics of accessing the program.

Just as FHLMC, which was originally restricted to doing business with thrifts, was launched with FHLBB (thrift) capital, user capital may be the most readily available source of capital for the Corporation.

Credit Risk

The value of the Corporation's equity would be heavily dependent on the credit risk inherent in its business. The small business concerns whose loans would be eligible for the proposed program would have net worth of $18 million or less and average net income no greater than $6 million. This defines a universe of relatively small, management intensive businesses that could be defined as "risky" from a traditional credit perspective. I am sure the lenders who testify can elaborate on this and will likely have their own opinions, which may or may not agree with my remarks. However, suffice it to say that we would expect that many of these loans will be unrated and likely unratable credits.

Retention of Risk. The proposed legislation provides that the Corporation will be able to guarantee timely payment on up to 80% of principal and interest on qualified loans and that the Corporation may purchase up to 80% of the principal amount of a qualified loan. While the retention by the lender of 20% of the risk of qualified loans guaranteed by or sold to the Corporation affords a measure of credit protection to the Corporation, there does not appear to be a requirement that the lender in fact retain that 20% risk. The Corporation should feel more secure if the originator of the loan who has evaluated the credit, including the capabilities of the borrower's management, itself retained that risk.

Transfer of Servicing. In the alternative, if the lender is permitted to sell its 20% interest, the legislation may require that the acquiror be a qualified servicer and that the servicing be transferred along with the 20% interest. Servicing is a key component of credit performance. If the servicer is required to have an ownership interest in the loans, on an equal priority with the risk of the Corporation, the interests of the Corporation (and its shareholders) are more likely to be well served.

Subordination. The legislation does not specify whether the 20% to be retained would be subordinated to or pari passu with the amount guaranteed or purchased by the Corporation. Additional credit protection would be afforded to the Corporation if the lender retained a subordinated interest. A bank lender which retained a subordinated interest would, under current regulation, be required to retain the principal balance of the subordinated interest (at a 100% risk weighting) on its balance sheet for purposes of calculating the amount of regulatory capital required to be held by the bank. (The regulations for thrifts would require capital to be held against a 100% risk weighting for the principal balance of the entire pool of loans.)

If the bank regulations were as onerous as the thrift regulations in this regard, a substantial portion of the benefit to the banks would be lost if the banks were required to retain a subordinated interest.

On the other hand, the credit risk to the Corporation would be diminished substantially if the lender retained a subordinated interest.

Loss Experience. The Consumer Bankers Association reported in its 1992 Small Business Banking Study that the average net loss on small business loans as a percentage of outstanding was .4% (as of September 30, 1991). The study also indicated that 96% of the respondents to the study had indicated that their practice was to renegotiate delinquent small business loans that would otherwise be charged off. This could account for the relatively low percentage of charge offs reported.

By comparison, commercial and industrial (C&I) loans in non-accrual status owned by the 353 bank holding companies in the U.S. with assets greater than $1 billion, as a percentage of total C&I loans owned, ranges from 0% to 47.9%; the weighted average (by size of C&I portfolio of loans in non-accrual status) is 4.05%. (W.C. Ferguson & Company, as of June 30, 1992.) It appears that a large percentage of the non-accruals are restructured rather than charged off.

The lenders will best be able to provide input on the extent to which loans are ordinarily restructured, and how -- lower interest rates, longer terms, etc.

Restructured Loans. The proposed legislation does not indicate whether restructured loans will be bought out of a pool by the lender or left in the pool. In either case, the Corporation, as guarantor, would be subject to credit risk: (a) the ability of the lender to buy the loan out of the pool; or (b) the guarantee that investors receive timely payment of principal and interest as initially promised, however the loan may be restructured.

Generally, a pool of loans which is not "actively managed" (actually or constructively reinvested in or exchanged for new loans) is classified as a grantor trust for tax purposes. Accordingly, the pool itself is not subject to tax. The Internal Revenue Service has provided limited guidance on the extent to which loans in a grantor trust may be restructured and left in the pool, generally situations in which a loan is in default or when default is reasonably foreseeable. If the loans may be bought out of the pool, that would result in an additional prepayment event for investors which would need to be taken into account in structuring and pricing the securities.

<u>Debt to Equity Ratio.</u>

The proposed legislation provides that on balance sheet as well as off balance sheet liabilities of the Corporation (i.e. obligations of the Corporation and obligations and securities guaranteed by the Corporation) outstanding at any one time may not exceed 30 times the sum of its capital (including for this purpose up to $300 million to be purchased by the Secretary of the Treasury after the Corporation has sold at least $30 million of common stock), capital surplus, general surplus, reserves and undistributed earnings (subject to certain exceptions). Section 7 (b).

This compares with the recently enacted standards for FHLMC and FNMA which set permanent minimum capital levels of -

(a) 2.25% of on balance sheet assets/40x debt to equity ratio
(b) .45% of off balance sheet obligations/222x debt to equity ratio

These standards are for institutions whose risk consists predominantly of single family residential mortgage loans.

It should also be noted that, in addition to leverage ratios, the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 imposed risk based capital standards (to be implemented within two years after the appointment of a new regulator) relating to the ability of the institution to withstand 10 years of extreme and sustained credit and interest rate stresses (based on historical experience), with a 30% add-on for management and operations risk.

<u>Additional Credit Considerations/Standard for Qualified Loans</u>

The proposed legislation provides minimum criteria for the long term fixed rate financing to be facilitated by the Corporation. Section 11 (b). Among other things the proposed legislation provides for a maximum term of the loan to 30 years in the case of land or facilities or up to 10 years in the case of equipment, but in no event longer than the useful life of the property. In our experience, a small business loan with a term in excess of seven years requires a credit policy exception and is considered to be a very long term loan, frequently entailing incremental credit risk. In addition, the legislation provides that no loan shall have a loan to value ratio in excess of 90%. This too might be considered high

The legislation also provides for the demonstration of sufficient cash flow to adequately service the loan and that there be in place adequate standards to protect the integrity of the appraisal process with respect to any loan. We believe that emphasis should be placed on the lender's knowledge of and experience with the management of the borrower, and the importance to the borrower of the loan being made. We also believe that it would be more conservative for cash flow from operations to be relied upon as the primary source of repayment. Appraisals frequently should be considered suspect in that it is often the case that appraisals, particularly with respect to equipment built or purchased for specific purposes, will not represent actual resale value, especially with the passage of time.

<u>Adequacy of Revenue to Cover Credit Risk</u>

The proposed legislation provides for fees not to exceed 2 1/2% of the principal amount of any loan guaranteed by the Corporation and included in a pool represented by securities guaranteed by the Corporation. Section 12.

While the Corporation's access to $1.5 billion from the Secretary of the Treasury will provide comfort to investors in large volumes of the small business loan - backed securities guaranteed or issued by the Corporation, equity investors cannot rely on that back stop and must be provided with compelling evidence that the Corporation's revenues are more than sufficient to cover its obligations.

Establishment of Criteria

Another foundation of the business of the Corporation will consist of the criteria for the loans which will be acceptable to the Corporation, for guarantee or purchase, the criteria for pooling loans, underwriting, appraisal and repayment standards for qualified loans and other terms. The legislation, as currently proposed, provides for the establishment of all such criteria after the election of the Board. This appears to refer to the permanent board, which would only be put in place after at least $30 million of common stock of the Corporation has been sold. Section 6 (b) (1).

Potential equity investors would likely have substantial additional comfort if these standards were put in place prior to the sale of capital stock.

GAO Audit of the Corporation

The legislation provides for the comptroller general to perform a financial audit of the Corporation. Section 17. We believe that the Corporation itself should also retain independent auditors to assure compliance with program standards of all institutions which contract with the Corporation.

II. Securities Guaranteed or Issued by the Corporation

The proposed legislation contemplates the issuance by certified poolers of securities that represent the guaranteed portion of principal and interest in, or obligations backed by, a pool of qualified loans held by the certified pooler. Section 10 (a) (1). In addition, the proposed legislation contemplates that the Corporation itself may issue securities based on the security of or backed by a participation in, pooled interests in the portion of qualified loans purchased by the Corporation. Section 10 (e).

Agency Securities

As indicated earlier, the Corporation would be chartered by the federal government as a government sponsored enterprise.

The proposed legislation permits the Corporation to borrow from the Secretary of the Treasury up to $1.5 billion for the purpose of fulfilling the obligations of the Corporation under any security issued by the Corporation or under any guarantee provided by the Corporation under the Act. Section 15 (a) (1). This limited draw on the Treasury is comparable to the access afforded to FNMA, FHLMC, Sallie Mae, Farmer Mac and the Federal Home Loan Bank System.

Based on the foregoing, we believe that the securities guaranteed by the Corporation as well as the obligation of the Corporation under any security issued by the Corporation, in either case backed by or representing interests in pools of small business loans, would be traded in the federal agency security market.

Benchmarks. For purposes of comparison, and to establish benchmarks, we would generally look to securities issued and guaranteed by or obligations of other federal agencies, such as FNMA, FHLMC, Farmer Mac and Sallie Mae.

Seven year straight non call debt obligations of FNMA and Sallie Mae, for example, trade at 20bp yield over the seven year Treasury obligation (currently 6.00%). FHLMC PCs and FNMA MBS with seven year average lives, by comparison, trade at approximately 80-85bp over the seven year Treasury obligation. PCs and MBS are subject to prepayment risk and, accordingly, investors need to be compensated for taking this risk.

The extensive data available on mortgage prepayments due to changes in interest rates minimizes the penalty that investors require as compensation for bearing mortgage prepayment risk. If there is similar data to indicate the propensity of a small business loan to prepay, that information is not yet known by the capital markets. This lack of prepayment history, as well as --possibly-- a lack of correlation between interest rate changes and prepayment rates, will cause investors to require a greater concession for incurring prepayment risk associated with small business loans. Our experience indicates that commercial loans may be prepaid as a result of a number of factors which may or may not be related to the relative level of interest rates, such as -

- sale of servicing of the loan (We have found that small business loan lenders and borrowers establish a working relationship on which the borrower relies, and that if the servicing were to be sold, the borrower may be more likely to prepay his loan and refinance with another lender);
- sufficient revenue in the business to permit prepayment;
- replacement of debt with equity;
- replacement of debt with lower cost debt, either as a result of improved credit of the borrower or of lower interest rates, or both.

Perhaps the lenders can provide additional insights in this area.

The lenders who testify later might also comment on the anticipated demand by borrowers for loans which are not subject to prepayment or provide for prepayment penalties (yield maintenance) in the event of prepayment. Any such provisions would result in spreads closer to the non call spreads previously referred to.

SBA/SBIC Program

Participation certificates issued and guaranteed by the Small Business Administration represent interests in pools of debentures issued by SBICs. The participation certificates provide for the pass through to investors of principal and interest payments made by the SBICs on the underlying debentures. Each of the underlying debentures has a ten year maturity, provides for semi annual interest payment and provides for principal repayment at maturity. Certain additional features (optional prepayment and acceleration event provisions), add a degree of complexity and uncertainty to the structure. The SBA guarantee carries the full faith and credit of the U.S. government.

Optional Prepayments. First, each debenture issued prior to March 25, 1992, provides for prepayment at the option of the SBIC obligor beginning after the fifth year after issuance. In year six, prepayments may be made at a price of par plus a premium equal to the coupon on the Debentures. The premium required to be paid declines ratably in each year thereafter. In the event that an SBIC elects to make an Optional Prepayment, the amount paid is passed through to the investors. While the prepayment premium is quite steep and is likely to fully compensate investors in most circumstances, this is a feature which creates uncertainty and, therefore, has some associated cost.

Debentures issued on or after June 24, 1992, provide for prepayment at the option of the SBIC obligo beginning six months after issuance at a premium equal to 105% of par, and at each year thereafte at 104%, 103%, 102% and 101%, respectively, until 5 1/2 years after issuance when the Debentures may be prepaid at par.

Acceleration Events. Second, and perhaps more significant, an SBIC's default, under the SBA's regulations, may result in either an automatic or a discretionary acceleration of the SBIC's Debentures In such an event (which is referred to as an Acceleration Event), the SBA makes a full prepayment of the Debenture which is passed through to investors.

Under its regulations, SBA may, in its sole discretion, declare an acceleration of an SBIC's Debenture upon the occurrence of any one or more of the following: (i) default in the payment of the principal or interest under any debenture, note or obligation of an SBIC, issued to, held or guaranteed by SBA. (ii) non-performance or violation by an SBIC, as determined by SBA, of any one or more of the terms and conditions of any loan or obligation of the SBIC issued to, held or guaranteed by SBA, or any agreement with or condition imposed by SBA; (iii) failure of an SBIC, as determined by SBA, to comply with any one or more of the provisions of the Small Business Investment Act or regulations promulgated thereunder, as such regulations may be amended from time to time; and (iv) failure of an SBIC to notify SBA within 20 days from the date of an event of default or non-performance by the SBIC under any debenture, note or indebtedness of the SBIC issued to or held by anyone other than SBA. Before such an acceleration is declared, SBA's standard operating procedures call for the transfer of the SBIC from operating status to liquidation status.

Notwithstanding the above, SBA regulations provide that a Debenture is automatically accelerated without prior notice to the defaulting SBIC whenever: (i) an SBIC is insolvent; (ii) not having sufficient property to pay all of its debts, an SBIC makes a voluntary assignment thereof; (iii) an SBIC makes any transfer or incurs any obligation that is fraudulent under the terms of 11 U.S.C. 548 (the Bankruptcy Code); or (iv) a petition is filed on commencement of any bankruptcy or reorganization proceeding, receivership, dissolution or other similar creditors' rights proceeding, by or against an SBIC, whichever event shall first occur. Whenever SBA learns of the occurrence of such an event of default it must transfer the SBIC into liquidation status.

The anticipated rate of and amount of prepayments of principal, if any, to investors as a result of Acceleration Events cannot be predicted. The uncertainty creates the most considerable cost to the SBICs.

SBA participation certificates are currently priced at a spread of approximately 80bp over the ten year Treasury. By contrast, FNMA and Sallie Mae debentures with ten year maturities and which can not be called during the life of the security are currently priced at a spread of approximately 25bp over the ten year Treasury. Although the SBA security has a full faith and credit guarantee, and the FNMA and Sallie Mae securities do not, the structural features referred to previously (i.e. acceleration in the event of a default by an SBIC and prepayment at the option of the SBIC beginning after the fifth year or after six months) result in the wider spreads for the SBA participation certificates. When some of those structural uncertainties are introduced into agency securities, such as GNMA pass-throughs, the spreads also widen for those securities. GNMAs have the benefit of a full faith and credit guarantee but are subject to mortgagor prepayment risk. Mortgagors generally have the right to prepay their mortgage loan without penalty or premium. Such a prepayment would be passed through to the GNMA investors. A GNMA with a 30 year maturity and, based on projected prepayments, a ten year average life would be priced at a spread of approximately 75 basis points over the ten year Treasury.

Potential Investors

There is a large universe of domestic and foreign investors who have participated in the mortgage and asset backed markets. Participation by particular investors will be dependent on a number of factors, including the following:

- average life of securities;
- prepayment risk;
- fixed or floating interest rate;
- state legal investment prohibitions (see Section 14(c) of proposed legislation);
- state security and real estate registration or qualification requirements (see Section 14 (b) (1) of proposed legislation);
- ERISA limitations (discussed below).

ERISA Limitations

The acquisition of an asset backed security by an employee benefit plan subject to the Employee Retirement Income Security Act of 1974 ("ERISA") could result in a prohibited transaction or other violations of the fiduciary responsibility provisions of ERISA and certain provisions of the Internal Revenue Code if, by virtue of such acquisition, the underlying assets (in this case the small business loans) were deemed to be assets of the plan. This ERISA restriction would eliminate certain potential investors.

Underwriters' Exemption. The Department of Labor ("DOL") granted a number of securities underwriters an administrative exemption from certain of the prohibited transaction rules of ERISA with respect to the initial purchase, the holding, and the subsequent resale by benefit plans of certificates in asset backed pass-through trusts that consist of certain receivables, loans, and other obligations that meet the conditions and requirements of the exemption. The receivables covered by the exemption include secured loans such as the small business loans we are discussing. The exemption will apply to the acquisition, holding, and resale of the Class A Certificates by a benefit plan, provided that specified conditions are met, including the following.

(1) The acquisition of the securities by a benefit plan is on terms (including the price for the securities) that are at least as favorable to the benefit plan as they would be in an arm's length transaction with an unrelated party;

(2) The rights and interests evidenced by the securities acquired by the benefit plan are not subordinated to the rights and interests evidenced by other certificates of the trust;

(3) The securities acquired by the benefit plan have received a rating at the time of such acquisition that is in one of the three highest generic rating categories from either Standard and Poor's Corporation, Moody's Investors Service, Inc., Duff and Phelps Inc. or Fitch Investors Service, Inc.;

(4) The investment pool must consist only of assets of the type which have been included in other investment pools; certificates evidencing interests in such other investment pools must have been rated (at the level specified in (3) above) for at least one year; and such certificates must have been purchased by investors other than plans for at least one year.

Exemption for Federal Mortgage Agencies. It should be noted that Department of Labor regulations provide that benefit plans may invest in mortgage certificates guaranteed by GNMA, FHLMC, or FNMA without concern that the underlying mortgages will be included in the plan's assets.

Liquidity

In order to establish sufficient liquidity so that the Corporation's securities are traded with reference to other agency securities, the market should reasonably expect that large volumes of securities will be brought to market.

FNMA has outstanding $445.0 billion of MBS securities (as of December 31, 1992) and FHLMC has outstanding $407.5 billion of PCs (as of December 31, 1992).

It should be noted that, despite the fact that we would suggest that the Corporation plan to issue at least $5 billion of securities in order to participate fully in the agency market, the first public agricultural loan backed issue guaranteed by Farmer Mac consisted of only $88 million of securities. We understand that those securities were sold at spreads of 100 to 105 over the applicable Treasury securities.

Certain Structures to Be Considered

The likelihood of loan prepayments and restructurings, the treatment of restructurings, the length of the terms of loans originated and a variety of other factors will dictate what structures will be most suitable for the Corporation's program. Certain of the structures which may be considered are outlined below.

- Fixed rate loans/fixed rate securities
  - investor takes prepayment risk

- Floating rate loans/floating rate securities
  - diminishes prepayment risk concern

- Fixed rate loans/floating rate securities
  - swaptions; i.e. swap of fixed rate payments for LIBOR, with an option to reduce the swap at any time in the amount of a loan prepayment

- Fixed rate loans/discount fixed rate securities
  - diminishes prepayment risk concern as a result of "windfall" to investor in the event of prepayment; lender keeps "excess interest"

- Revolving structure
  - invest loan principal payments and prepayments in new loans for a specified period, which would eliminate investor prepayment risk for that period.

There are advantages and disadvantages, including costs and risks, associated with each structure which must be evaluated within the framework of the actual characteristics of the pools of loans to be guaranteed by the Corporation and the Corporation's overall objectives.

APPENDIX A:

Comparison of Non-Guaranteed Government Sponsored Enterprises

		VELDA SUE	Farmer Mac	FHLMC	FNMA	Sallie Mae
Credit Ratings:	Moody's	N/R	N/R	Aaa	Aaa	Aaa
	S&P	N/R	N/R	N/R*	N/R*	N/R*
Implied Governmental Support						
Chartered by Act of Congress		Yes	Yes	Yes	Yes	Yes
May Borrow from Treasury		$1.5BN	$1.5BN	$2.25BN	$2.25BN	$1BN
Owned by Government		No	No	No	No	No
% of Board Appointed by President		44.4%	33.3%	27.8%	27.8%	33.3%
Bonds Exempt from SEC Registration		No	No**	Yes	Yes	Yes
Profit Profile						
1992 Return on Equity		N/A	N/A	17.5%	24.0%	32.3%

* Qualified by S&P as investments for AAA debt.
** No for mortgage backed securities but Yes for debt issuance.

IBAA
INDEPENDENT BANKERS
ASSOCIATION OF AMERICA

March 8, 1993

The Honorable John J. LaFalce
Chairman
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515

Dear Mr. Chairman:

I am enclosing replies by Mr. William Gossett, president of Liberty National Bank, Longwood, Florida, to the written questions that you and Representative Meyers submitted as a follow-up to the hearing on Velda Sue legislation.

Thank you for the opportunity to testify and provide this additional information.

Sincerely,

Stephen J. Verdier

Stephen J. Verdier

Enclosure

cc: Representative Jan Meyers

Send Gossett

WASHINGTON OFFICE, ONE THOMAS CIRCLE NW, SUITE 950, WASHINGTON, D.C. 20005-5802 • 202/659-8111

REPLIES TO QUESTIONS
of
REP. JOHN J. LaFALCE
by
WILLIAM GOSSETT

Questions: If a prospective small business borrower comes into your bank and is a good credit risk and needs $1 million for plant and equipment —

a. can you help him solely through your bank, and if so, at what interest rate, fixed or variable, and over what years' term?

b. if you cannot help him by yourself, the SBA's 7(a) guaranteed loan program might be available, and both of you participate in it. Thus you might provide the $1 million with a 70% SBA guarantee for a maximum of 25 years at an interest rate of 2.75% over prime, which today's Wall Street Journal reports at 6%. What possibilities do you see here and particularly would the interest rate be fixed or variable?

c. the SBA's certified development company is another possibility. You might provide a first mortgage loan for $500,000 and the borrower would reject $100,000 and a certified development company could provide another $400,000 through the CDC program. Since both of your banks participate in the program, what interest rate, fixed or variable, would you want for your first mortgage financing of $500,000 (assuming that the CDC note rate continues at the January 20-year rate of 7.9%)?

d. what about under Velda Sue, if we assume that Mr. Altarescu and Mr. Terrell are loan poolers and will buy 80% of the loan; what interest rate do you see on the other 20%?

e. now let's change the scenario and have a borrower who does not qualify under the SBA size standards but does meet the higher Velda Sue Standards and who needs, for example $3 million or $5 million, amounts which are well outside the scope of the usual SBA maximum of $750,000. What can your bank do on its own and what can it do if you can again sell 80% to Goldman Sachs or to First Boston?

Answers:

a. This loan would exceed bank's legal lending limit and could not be made without assistance. $1,000,000 loan request from a creditworthy borrower for plant and equipment:

We would automatically screen the loan for other possibilities, specifically SBA programs. Also, if the potential borrower represents a very good credit

risk, we would attempt to handle utilizing a participating bank. The probable rate and terms with a participating bank would be:

Rate	-	Prime + 1.75% to Prime + 2.75% Adjusted quarterly, or 9.0% fixed
Fee	-	1.0% to 1.5%
Repayment	-	15 to 20 year amortization, 5 year balloon.

b. Same request under SBA 7(a):

Bank would be very interested in extending the normal SBA 7(a) loan with a $750,000 SBA guarantee. The rate would be Prime + 2.75%, adjusted quarterly, 25 year maturity. The guaranteed portion would be sold into the secondary market.

If borrower shows promise of being a very desirable customer, bank would consider fixing the rate on the guaranteed portion at 8.75% based on today's Prime and would float the rate on the non-guaranteed portion at Prime + 2.75%, adjusted quarterly. The maturity would be 25 years.

c. Same loan under SBA 504 Program:

40% funded by CDC at 7.9%, 20 year maturity. Bank would extend $500,000 as follows:

Rate	-	Prime + 1.75% to Prime + 2.50%, adjusted quarterly
Fee	-	1.0 to 1.5%
Repayment	-	20 year amortization, ten year balloon.

The loan will have to meet the criteria and intent of the 504 Program. This is a less desirable alternative from the bank's viewpoint since it utilizes $500,000 of bank funds for long period of time vice $250,000 under the 7(a) Program. Utilizing the 7(a) program would allow the bank to make another loan to another borrower.

e. $3,000,000 to $5,000,000. A loan of this amount exceeds our bank's ability to fund under any presently available options.

- or -

VELDA SUE - Bank could handle loan of up to $2,500,000 to $3,000,000 range assuming sale of 80% into a secondary market. The amortization could be up to 25 years, comparable to the SBA 7(a) program. Due to the size of our bank, we would prefer a floating rate on the bank-retained 20%

to avoid excessive interest rate risk. Interest rate on the 80% portion to be sold could either float or be fixed depending on the needs of the borrower and market conditions for the loan.

REPLIES TO QUESTIONS
of
REP. JAN MEYERS
by
WILLIAM GOSSETT

Questions:

A. Could you please provide me with a detailed list of regulations and other government impediments that, if eliminated or simplified, you think would help you in your small business lending?

B. You state in your testimony that you believe many "character" or judgment based loans are being regulated out of the commercial lending market, and that such loans will not pass the test for a secondary market. Given that assumption, who would Velda Sue help in the current regulatory climate?

Answers:

A. - *Many of the present impediments emanate from FIRREA or FDICIA with impact on lenders through regulatory attitudes and are difficult to quantify or verbalize.*

- *Although this example is not small business related, it illustrates the problem. Our bank does not extend 1 to 4 family residential loans or home equity lines of credit. Our lending officers are capable of underwriting a million dollar commercial credit and would be perfectly capable of underwriting a $50,000 home mortgage. We are very straightforward in our dealings with customers, treating everyone fairly. Yet, we do not wish to assume the compliance risk involved in home mortgage lending and do not believe that we would generate a sufficient volume of home loans to justify hiring the expertise to deal with the related compliance matters.*

  This is a case of the government attempting to protect the public with burdensome and unnecessary regulations. In reality, the government is depriving the public of a competitor.

  At this point we understand that the government is considering extending RESPA to involve our commercial loans that utilize as additional collateral second mortgages on 1 to 4 family property. This is a serious and unnecessary mistake.

- *Specific areas that translate in to reduced lending as result of regulatory attitudes include:*

- *Harsh examiner classifications of loans.*

- *Overly stringent standards in justifying new credits and renewing existing credits.*

- *Excessive loan underwriting standards and documentation requirements.*

- *Excessive documentation and justification requirements for loan loss provision.*

- *Micromanagement of internal bank reporting processes and excessive amount of regulatory required reports.*

- *CRA paperwork requirements that divert time away from new lending efforts.*

- *Unnecessary creation and re-writing of bank policies. (Our bank out performs our peer group by a wide margin, yet we had to write or re-write the following policies to conform to regulatory "one-size-fits-all" expectations: Asset/Liability Management, Loan, Investment, Appraisal, Capital Plan, Strategic Plan. For what purpose?)*

- *Regulatory mandated appraisal standards and loan-to-value expectations. These didn't work with the S&L's of yesteryear - government can't legislate away bad judgment and incompetence! Balanced examination policies are the answer.*

- *Overly restrictive insider loan provisions under Regulation O.*

- *Excessive civil money penalties for Bank Officers and Directors.*

B. - *My expectation is that VELDA SUE would provide funds for the long term credit needs of small to intermediate sized businesses. Maturities of the loans would be ten years or greater, fully amortized. Proceeds of the loans would be used for refinancing or acquisition of fixed assets, primarily owner occupied real estate and machinery and equipment.*

Responses by James Murphy
Executive Vice President, Fleet Financial Group
to Questions from Chairman LaFalce Regarding H.R. 660
the "Small Business Credit Availability Act of 1993"

If a prospective small business borrower comes into your bank and is a good credit risk and needs $1 million for plant and equipment - - -

a) Can you help him solely through your bank, and if so, at what interest rate, fixed or variable, and over what years' term?

Fleet would be able to make such a loan and would negotiate on terms that meet the borrower's particular needs. Of course, the terms of the loan would depend on the borrower's financial track record, character, the equity he or she has in the collateral and an evaluation of the company's business situation.

Whether the interest rate is fixed or variable would largely depend on the term desired by the borrower and the price he or she is willing, or can afford, to pay. Fixed rates are easily obtainable, but variable rates are normally cheaper than fixed rates. However, the nature of fixed rates dictates increasingly higher costs for longer maturities. Borrowers normally prefer a variable over a fixed rate as they are less sensitive to the risk of rising interest rates than increased pricing.

b) If you cannot help him by yourself, the SBA's 7(a) guaranteed loan program might be available, and both of you participate in it. Thus you might provide the $1 million with a 70% SBA guarantee for a maximum of 25 years at an interest rate of 2.75% over prime, which today's Wall Street Journal reports at 6%. What possibilities do you see here and particularly would the interest rate be fixed or variable?

The 70% SBA guarantee would be helpful, and Fleet would work with the borrower to structure terms and an appropriate rate for the remaining 30% of the loan. It is unlikely that under current policies a bank would lend operating capitol for 25 years except for guaranteed amounts. Even if a bank would make such a loan, it would have to be at a fixed rather than variable rate, which would be costly for the borrower.

The development of a secondary market, with workable underwriting standards, would make such loans easier at fixed rates. The right sort of guarantee, whether federal

government or otherwise, would also reduce the price on these loans.

c) The SBA's certified development company is another possibility. You might provide a first mortgage loan for $500,000 and the borrower would inject $100,000 and a certified development company could provide another $400,000 through the CDC program. Since both of your banks participate in the program, what interest rate, fixed or variable, would you want for your first mortgage financing of $500,000 (assuming that the CDC note rate continues at the January 20-year rate of 7.9%)?

An interest rate, either fixed or variable, for the scenario you describe in this question is difficult to determine without further information about the structure of the loan, including subordination rights. For instance, the bank would not want to get into a situation where its interest in the loan was subordinated to that of another lender or guarantor. However, Fleet would work with the borrower to find acceptable terms for the loan.

In a general sense, the administrative costs of making these types of loans can be prohibitive. For example, the appraisal requirements and regulatory reporting rules make $1 million loans as expensive as much larger loans. However, the development of a secondary market that allowed banks to sell the loans, and therefore permit defeasance, would encourage more of these loans, perhaps for longer terms and at fixed rates. The key is to make sure that regulatory rules are put in place that allow banks to act as a conduit for the loans and not retain the risk on their books.

d) What about under Velda Sue, if we assume that Mr. Altarescu and Mr. Terrell are loan poolers and will buy 80% of the loan; what interest rate do you see on the other 20%?

It is difficult to price this type of transaction, and thus set an interest rate for it, without actually having a secondary market in place. However, if we assume: 1) that an investment banker would buy 80% of the loan and leave 20% of the loan to the bank to price; 2) that the portion left to the bank is not covered by a guarantee; and 3) is in a first loss position, the interest rate for that part of the loan would be expensive, as the bank retains all of the risk of loss. This could be alleviated by the development of an effective secondary market with strong underwriting standards, where the bank's position is not substituted for guarantees.

e) Now let's change the scenario and have a borrower who does not qualify under the SBA size standards but does meet the higher Velda Sue Standards and who needs, for example $3 million or $5 million, amounts which are well outside the scope of the usual SBA maximum of $750,000. What can your bank do on its own and what can it do if you can again sell 80% to Goldman Sachs or to First Boston?

Fleet is already actively lending in this range, and it is widely viewed as one of the prime areas left to banks. Having a guarantee for $3-5 million loans would be attractive, but there is no certainty that it would increase lending. In fact, with respect to the Northeast, Fleet has had no trouble meeting the current demand for these middle market loans. However, if the focus was placed on less creditworthy companies, the guarantee provided by Velda Sue could enhance lending to such businesses, but it would also increase the risk of loss to the guarantor as well as the lender.

Responses by James Murphy
Executive Vice President, Fleet Financial Group
to Questions from The Honorable Lucille Roybal-Allard
Regarding H.R. 660,
the "Small Business Credit Availability Act of 1993"

1) You mentioned the average small business loan in your portfolio was a loan of $55,000. Most of the small businesses seeking credit in the communities I represent would probably be seeking considerably smaller funds, at what level would a bank generally not consider extending a long-term rate loan to a small business? $1,000 or $5,000 or $10,000.

There is a legitimate need for "micro" loans to small businesses and at Fleet there is no lower limit on the size of the loan. We are constantly trying to make our systems more efficient so we can service the small business loan market more effectively and at better prices for our borrowers.

We also feel that there is an obligation to counsel the borrower on what types of loans are best for his individual situation. Broadly speaking, the less money that is borrowed, the less time should be needed to repay the loan, and this generally works to the advantage of the borrower because it reduces interest costs.

For example, we would make a $10,000 loan to a business for a term of 10 years if that firm's cash flow required it. However, although we would also make a three-year $1,000 loan to the owner of a pizza business for a new oven or other equipment, chances are that the loan officer would counsel against such a relatively long period because of the high interest expense (in relation to the size of the loan) that would be borne by the borrower.

2.a.) Does Fleet Financial Group have any experience working with community development corporations (CDC's)?

Fleet does have a great deal of experience in working with community development corporations. As you can see from the attached letter I submitted to Senate Banking Committee Chairman Don Riegle on February 17, 1993, many of Fleet's community lending programs are formed and implemented through close cooperation with community groups and development organizations.

2.b.) Would the types of small loans made by CDC's be too risky for Velda Sue, assuming Velda Sue adopted underwriting standards similar to those SBA has used?

We do not believe that the assumption that CDC loans would be impaired in some way is necessarily true. It is our understanding that a secondary market for small business loans that would be put in place by H.R. 660 is not intended to create a funding crutch for distressed or substandard companies. We view the new market as another source of funds for small businesses, and any loan that conformed to the underwriting standards implemented by Velda Sue's board could be sold, packaged into a pool and securitized. It is possible, however, that once the market is established, special niches with different underwriting standards, could also be developed to deal with some of the more "risky" types of loans.

Attachment: James Murphy letter to Chairman Riegle

Fleet Financial Group

James P Murphy
Executive Vice President

February 23, 1993

The Honorable Donald W. Riegle, Jr., Chairman
United States Senate Committee on
Banking, Housing and Urban Affairs
SD-534 Dirksen Senate Office Building
Washington, DC 20510-6075

Dear Mr. Chairman:

During his testimony before your Committee on February 17, 1993, John Hamill, President of Fleet Bank of Massachusetts, mentioned that Fleet Financial Group has shown its commitment to increased lending, affordable housing and providing better products and services to low-to-moderate income and minority neighborhoods through a variety of programs initiated by its banks and mortgage subsidiaries.

I would like to take this opportunity to provide you and the Members of the Committee with a more detailed description of our major programs in this area, some of which include:

- Providing $370 million over the last five and one-half years in New York City to finance end loans for the acquisition of 4,800 one-to-four family homes for people with family incomes of between $22,000 and $40,000 per year.

- The "Jump Start Program" which was initiated on January 1, 1992 by our Rhode Island bank to provide home ownership to low-to-moderate income families through $10 million in low interest, no down payment financing for first time home buyers with incomes of no more than $23,000 per year.

- A $111 million community lending investment program for low and moderate income neighborhoods in Massachusetts, initiated in June 1991, which will create over 1,750 affordable houses in Boston and across the state, as well as channel over $7 million to help minority-owned and other small businesses.

Fleet Financial Group Inc [illegible] New York New York [illegible] 212-907 5025 / Fax 212-907-5615

The Honorable Donald W. Riegle, Jr., Chairman
United States Senate Committee on
Banking, Housing and Urban Affairs
February 23, 1993
Page 2

- A construction lending program for affordable housing in conjunction with the New York City Partnership, New York State and New York City housing agencies which provided $40 million in loans in 1992 and will provide as much as $100 million in 1993.

A detailed description of these, and other major programs initiated by Fleet is contained in the attached memorandum. I request that this letter and attachments be made part of the official record for your February 24, 1993 hearing dealing with "Redlining".

We would be pleased to answer any questions you or your staff may have about this material, and to provide additional information that you feel would be helpful to the Committee.

Sincerely,

James P. Murphy

James P. Murphy

cc: Members of the
Senate Banking Committee

FLEET FINANCIAL GROUP
LOW AND MODERATE INCOME COMMUNITY LENDING PROGRAMS

Fleet Financial Group (Fleet) has been very active in community lending and has a comprehensive and effective Community Reinvestment Act (CRA) compliance program in place. A good example of our efforts is New York city where over the last five and one-half years we have provided approximately $370 million to finance end loans for the acquisition of one-to-four family homes for people with family incomes of between $22,000 and $40,000 per year. This program has created 4,800 units of new affordable housing, 90 percent of which are owner-occupied by minorities.

In fact, Fleet's banks all received either "outstanding" or "satisfactory" CRA ratings in their most recent examinations.[1/] In addition, when the Federal Reserve Board (Fed) reported discouraging industry-wide statistics in 1991 and 1992[2/], as required by the Home Mortgage Disclosure Act (HMDA), showing that racial disparities exist in mortgage application approval rates, Fleet acted quickly to: (1) gather more data; (2) plan and implement an aggressive effort to make its CRA compliance programs more effective; and (3) increase mortgage loans to low-to-moderate income and minority borrowers.

In November 1991, Fleet established a corporate HMDA/CRA task force under the direction of Executive Vice President Jim Murphy. The task force's mission was to research and study the facts concerning the disparities in approval rates by race, resolve HMDA/CRA systems and reporting issues, and evaluate Fleet's products in meeting the needs of low-to-moderate income and minority communities. By the middle of 1992, the members of the task force, working with Fleet compliance personnel and outside HMDA/CRA compliance consultants, finished an assessment of the HMDA/fair lending programs at each Fleet bank and mortgage company.

Although the results of this self-assessment program did not reveal any discrimination against applicants, it did show that HMDA data collection and reporting systems needed improvement, fair lending compliance management processes needed strengthening, and increased training was needed overall in these areas. Fleet immediately took the following steps:

1/ See attached.

2/ HMDA statistics for 1990 (the first year for compiling such data), which included data on loan applications for new home purchases, mortgage refinancing and home improvements, were made public by the Fed in October 1991, and data on 1991 loan applications were reported in 1992.

1. Purchased a new "Centrax" system (a computer-based data processing system) which will improve data processing and tracking and timely management reporting.

2. Held discussions with local community groups to solicit their suggestions, then took action to improve existing bank products by making them more responsive to community needs, particularly in low income and minority urban areas. For instance, flexible first mortgage products for low-to-moderate income borrowers are now being aggressively marketed throughout all Fleet banks and mortgage companies, which include:

   - More flexible underwriting guidelines that take into consideration timely payment of utility bills and rent as proof of financial responsibility, rather than just looking at a potential borrower's payment history on installment loans or bank credit.

   - Instead of requiring a 5 percent downpayment on a loan to come directly from the borrower, the new guidelines allow 2.5 percent to come from a gift, grant or loan.

   - A "second look" program whereby an application that has been declined will be looked at again by a senior manager.

3. Put in place dozens of affordable housing programs throughout its system, and improved CRA programs and products.

4. Began talks with representatives of Fannie Mae and others regarding the joint development of a new low-to-moderate income mortgage product.

Our goal is to help poor and minority neighborhoods stabilize their communities, to inject equity into those communities and provide a basis for home-ownership initiatives and promote small business activities. The attached memorandum summarizes some of the major affordable housing and CRA programs currently being implemented by our banks and mortgage subsidiaries.

Fleet does not condone or in any way tolerate discrimination against minorities or the practice of "redlining" certain communities. In fact, as indicated by the scope of the specialized programs we offer at all of our banks and subsidiaries, Fleet actively pursues opportunities to help provide more credit to disadvantaged areas and works closely with

local government officials and community leaders to formulate and implement programs tailored to those communities.

The HMDA statistics reported by the Fed, although flawed because they do not provide an assessment of all the important criteria used in the mortgage approval process, are a wake up call to the industry to do a better job. Fleet has and will continue to be a leader in this important effort.

FLEET FINANCIAL GROUP
LOW AND MODERATE INCOME COMMUNITY LENDING PROGRAMS
(By State)

1. Rhode Island

- Jump Start Program: A innovative program called "Jump Start" was initiated on January 1, 1992 to provide home ownership to low to moderate income families. Fleet's Rhode Island bank joined with the Rhode Island Housing and Mortgage Finance Corporation (RIHMFC) and Commonwealth Mortgage Assurance Company to provide $10 million in low interest, no down payment financing for first time home buyers with income of no more than $23,000 per year. To date, over $4 million has been booked under this program (see attached press release).

- Lease to Buy Program: Another program, done in conjunction with RIHMFC provides financing to low to moderate income Rhode Islanders to purchase a first home through a unique two-year lease purchase agreement. Over $3 million has been committed to this program (see attached press release).

- Line-of-Credit Program: A program providing a $1 million restoring line-of-credit, priced at 2 percent over Fleet's passbook rate, was initiated to provide construction and renovation financing to non-profit companies to increase affordable housing stock. Over $1.7 million has been used to date.

2. Massachusetts

- Community Investment Lending Program

  On June 27, 1991, shortly after it acquired control over the banking subsidiaries of the former Bank of New England from the FDIC, Fleet initiated a $111 million community lending investment program for low and moderate income neighborhoods and communities in Massachusetts as part of a broader program designed to pump more than $500 million in new capital into the New England economy. This included an $11 million mortgage assistance program to help homeowners with burdensome mortgage loans (see attached press release).

  The plan, which has been very successful, will create over 1,750 affordable houses in Boston and across the state. It will also channel over $7 million to help minority-owned and other small businesses.

3. New York (New York City/Long Island)

- End Loan Financing

  Over the past five years, Fleet has made a concerted effort to become a leader in New York City in providing affordable housing and finance. Through Fleet Mortgage, it provided approximately $370 million in financing for the end loan financing of approximately 4,800 units of new 1-4 family housing in Brooklyn, Queens, the Bronx and Manhattan. This included end loan financing for 2,200 units of Nehemiah housing in Brooklyn by a coalition of churches and synagogues.

- Construction Lending Program

  Beginning in 1991, Fleet's New York City bank began developing an active construction lending program for affordable housing by working with the New York City Partnership, New York State and New York City housing agencies, and various for-profit and non-profit developers and sponsors. In 1992, $40 million in loans were booked, and as much as $100 million may be booked in 1993.

- New York Mortgage Coalition

  On January 29, 1993, a two-year commitment was given to the New York Mortgage Coalition for $50 thousand a year for administrative costs with the understanding that Fleet will make approximately $5 million in loans each year. The program also include "second look" loan restructuring and credit counseling.

- Micro Loan Program

  A pilot "micro" loan program was initiated in the minority communities of Hempstead and Glen Cove, Long Island, with an anticipated commitment of $150 million to each, plus administrative support.

- Other programs in 1992 include:

  $5 million in co-funding for the start-up of a small business development center at Pace University in Harlem; a $10 million grant for neighborhood housing services.

New York (Upstate)

- Portfolio Lending

  Fleet Bank of New York, in conjunction with the Neighborhood Housing Services, developed a new portfolio mortgage product targeted to low to moderate income populations living in distressed areas throughout Upstate New York. A partnership of 32 community organizations participate with the Bank to provide credit and home-ownership counseling and assist in collecting potentially delinquent payments. A commitment of $12 million has been allocated.

- "Second Look" Program

  In February 1992, the Bank implemented a "second look" program to ensure that fair lending practices are consistently in place. The "second look" program entails a second review of minority HMDA related loans by a senior consumer officer before the credit is denied to a minority applicant. Under this initiative, the Bank considers all options or restructuring opportunities through the use of more flexible underwriting guidelines to facilitate mortgage applicants.

- Targeted Advertising/Community Diversification

  In 1991, Fleet Bank increased its emphasis on marketing which is targeted to minority communities. New ads, utilization of minority models, advertising in minority publications and the development of poster ads to reach our communities through branch and neighborhood networks have been initiated. Additionally, product brochures have been published in Spanish. Fleet Bank convened focus groups in Albany and Rochester in an effort to learn from minorities how best to serve minority consumers.

- Workforce Diversification/Outreach

  A full-time employee has been assigned to recruit and develop minority employees. During 1992, Fleet Bank contacted approximately 210 organizations to determine ongoing credit needs (with primary emphasis on affordable housing) through the Bank's Direct CRA Calling Program.

Connecticut

- HART/Frog Hollow First Time Home Buyers Program

  In August 1990, Fleet became a pioneer participant in this Hartford program by making a $1,000,000 commitment. This program is aimed at low/moderate income buyers in Hartford.

- Southend Institutions Neighborhood Alliance

  This is a $1,000,000 commitment for home mortgages in Hartford.

- New Britain Neighborhood Preservation Program

  This program is designed to aid homeowners for home improvements with low interest loans in collaboration with the City of New Britain. Fleet Bank has been involved with this program for 19 years. The total current commitment of the banks is $600,000, with Fleet's share at $85,000.

- Fleet Banker's Pool with Neighborhood Housing Services of New Britain

  These funds are used for the acquisition and renovation of residential properties with low rates and flexible terms. There is a $1,500,000 total bank commitment with Fleet's share at $215,000.

- Thomas Valley Council for Community Action

  The Thomas Valley Council for Community Action (TVCCA), through its Housing Advisory Committee, is involved with housing projects in New London county. Childhood development, nutrition and neighborhood services are also areas of involvement. Fleet Bank is represented on the Finance Committee.

- Broad Park Development -- Hartford

  Fleet financed Jefferson-Seymour, an affordable housing project, in Hartford.

- Fairfield 2000 House Corporation (F2HC)

  Fleet Bank has committed to a Fairfield County project consisting of 16 homes which are currently owned by the U.S. Army and which will be sold to low/moderate income households. Fleet Bank is represented on the Board of Directors.

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- <u>The Affordable Housing Funds for Connecticut</u>

  This $5 million tax credit fund provides low/moderate income families with affordable housing throughout the state. It has developed 281 units of affordable housing and 7 retail stores in four years. Among its projects are Hartford's Sigourney Mews and Bridgeport's East Main. Fleet Bank is represented on the Board of Directors.

- <u>New Haven Infill Program</u>

  In collaboration with the City of New Haven, Fleet Bank has committed $1,000,000 to provide home buyers with mortgages for homes constructed on vacant lots in the City.

- Fleet Bank, with Legislative leaders, created the State Home Mortgage Task Force, made up of community leaders, public officials, mortgage lenders and banks. From this group came several home mortgage initiatives:

  A state law that permits interest in real estate escrow funds to be used for private mortgage insurance. The Connecticut Alliance of Homeownership Opportunities was then formed to purchase these loans. $16 million was committed for this purpose by Hartford insurance companies.

  A Review Committee has been created to monitor minority mortgage applications and analyze results on an ongoing basis.

  The State's Mortgage Down Payment Assistance Plan has been rejuvenated and the Department of Housing has taken a more aggressive approach to utilizing funds available.

  A centralized approach to First Time Home Buyers education programs is being developed.

  CHAMP (Connecticut Homebuyers Affordable Mortgage Program), a program of flexible credit standards and low down payments, was created. This program has commitments from banks statewide of over $75 million.

5. Maine

- Port-Lender Homeownership Project

  Fleet Bank is among five Maine banks who have each pooled $250,000 for the Port-Lender Homeownership Project, a pilot homeowner/landlord program administered by the City of Portland's Community Development Office.

  The project represents a significant public/private partnership between the banks and the City. The program's goal is to improve the stability and livability of 1-4 unit properties in Portland's older neighborhoods by increasing owner-occupied properties and renovating local neighborhoods.

- City/Bank Housing Rehabilitation Loan Program

  The City of Portland annually receives a Community Development Block Grant under Title I of the Housing and Community Development Act of 1974. As part of their Community Development Program, the City assists low and moderate income property owners in the City of Portland.

  Fleet Bank's participation is to provide one-half of the amount of a housing rehabilitation loan, matched by a loan of a similar amount by the City, for eligible one-to-eight unit properties, containing a majority of households with low and moderate incomes. The aggregate amount the bank agrees to lend annually is $200.000. Presently Fleet bank has 22 loans totalling $95,000.00.

- Bangor Hydro-Electric Company Residential Conservation Loan Program

  The purpose of the program is to provide low cost funds to Bangor Hydro customers for rehabilitation for reducing electrical consumption/costs. Fleet has renewed its commitment to this program for 1992-93, and is the only participating lender underwriting these reduced rate low cost loans. Current volumes as of 9/13/92 are 21 loans at $72,000.00.

- Western Maine Land Trust, Six Unit Low-Low Income Affordable Housing Project-Porter Hill Farmington

  Fleet has committed to finance a $75,000 one year construction loan for three of the units, and subsequently finance the units (through FREF). MSHA

also plans to finance three units. All six units will follow the MSHA Home Start Program specifications. This project will benefit six low-low income families in the Farmington area.

- Lewiston Housing Opportunity Zone (HOZ) Program

  Fleet and several other local banks are working with the City's Community Development Director for the purpose of implementing a program similar to the Portland Port Lender's Project in Lewiston. Fleet has committed $250,000 to the project, which will benefit first time homeowners.

6. New Hampshire

- Seacoast Affordable Housing Project: Fleet is the lead participant in a $100 million commitment to the Seacoast Community Banking Council for a loan pool that supports affordable housing in that region of New Hampshire. So far, we have loaned over $179,000, which has financed 48 housing units.

- Concord Community Investment Pool: The bank is also a participant in a $500,000 commitment to the Concord Community Housing Investment Pool, which also provides affordable housing in the Concord area. To date, over $280,000 has been loaned to finance 34 housing units.

- Neighborhood Housing Services: It is also active in two Neighborhood Housing service groups in Manchester and Nashua, and participates in loan pools and in providing operating money.

Responses by James Murphy
Executive Vice President, Fleet Financial Group
to Questions from the Honorable Jan Meyers Regarding H.R. 660
the "Small Business Credit Availability Act of 1993"

1) Your testimony suggests that Velda Sue might be of help to small business lending in economically distressed areas. Do you think the minimum underwriting standards in Velda Sue would be useful in those areas, or helpful to those small businesses?

If investors view Velda Sue's guarantees as acceptable, the market will be effective in assigning and pricing risk. Good underwriting standards are necessary to accomplish this, but overly stringent standards would not be helpful to less creditworthy businesses in "distressed" areas. Note, however, that it is a mistake to characterize all businesses in such areas as substandard.

Once the secondary market is established, it may be possible to establish separate niches with different or expanded underwriting standards for more risky businesses in distressed areas. The success of such an effort, of course, would depend on how that risk is priced by the market.

2) Fleet is a major 7(a) lender, and you do $1.6 billion in small business lending, about 5% of your loans. What percentage of your loans are in other areas? Could you provide a breakdown of your lending in other areas? Also, please provide a breakdown of your small business lending history and losses over the last ten years.

As I stated, approximately 5% ($1.6 billion) of Fleet's total lending is to small businesses. The attached chart provides a breakdown of our loans and losses by type for 1992 and 1993. We do not have figures available for prior years because systems in place prior to 1992 did not track loans this way -- all business loans were combined into one category called "commercial and industrial" loans.

3) Could you comment as to why you believe your colleagues in the larger banks are not interested, or able to lend to small businesses?

Fleet views small business lending as a profitable and worthwhile endeavor that it is actively pursuing. It is my feeling that the industry as a whole progressively sees small business lending as worthy of emphasis.

4) You stated at the hearing that perhaps $50 million in small business loans would be retired over the next few days and that Fleet would like to loan that money out to small business. What is preventing you from doing so?

During the hearing, I explained that our $1.6 billion small business loan portfolio was not a "static" situation because "$20 or $30 or $50 million of those loans will be paid off today." I did not mean to imply that Fleet does not replace those loans with new loans. In fact, our portfolio is constantly changing with old loans being paid off and new loans coming in. Nothing is preventing us from making new loans -- and we do -- but the formation of a secondary market could help us make even more loans than we do now. I am sorry for any confusion my original statement has caused you.

5) Do you think that participation in Velda Sue might deprive a small business borrower of some of the flexibility and access necessary to the average small businessperson, should they need to renegotiate or refinance.

We do not believe that a company that is considered a reasonable credit risk would be shut out of other markets, or the ability to renegotiate or refinance a loan, or future financing by participating in the Velda Sue program.

Attachment: Chart "FFG Loans and Leases"

FFG LOANS AND LEASES

	12/31/92		1/31/93	
Commercial	10,424,911	45%	10,191,782	45%
Consumer	7,795,869	34%	7,789,275	34%
Commercial R/E	4,722,008	21%	4,741,987	21%
Leasing	26,775	0%	38,977	0%
TOTAL	$22,969,563	100%	$22,762,021	100%

Statement of
Dr. Harry P. Guenther
Cohodas Professor of Banking and Finance
Northern Michigan University

to the
Small Business Committee of the
U.S. House of Representatives

on H.R 660
the Small Business Credit Availability Act of 1993

February 1993

Introduction

My name is Harry Guenther. I am currently the Cohodas Professor of Banking and Finance at Northern Michigan University. In addition to twenty five years of teaching in the fields of banking and finance, I have served as Executive Vice President and Economist of the Conference of State Bank Supervisors, as President of the bank research and consulting firm, Carter Golembe Associates, and as Dean of the Georgetown School of Business. For the past fifteen years, since the Inter-agency Task Force study of small business finance in the late 1970s, I have concentrated my research and writing on small firm financing, especially the impact of bank regulation on small firm financing. I am currently working under a Peter White research grant studying the issues relating to the creation of a secondary market for loans to small business.

It is widely acknowledged that small business firms have been the primary engines of job creation over the past decade and that they are expected to continue being such throughout the 1990s. For this reason if for no other there is good reason to explore avenues for facilitating the creation and growth of such firms. It also is an established fact that one of the chronic problems facing new and small firms is access to capital on reasonable terms. Thus in exploring avenues for facilitating the creation and expansion of small firms, we would be well advised to consider ways in which capital availability can be enhanced and/or its cost reduced.

There really are only two ways in which capital can be made more readily available or made cheaper for small firms: 1) by substituting for market forces by some means of public intervention; and 2) by improving the economic efficiency of the capital market, or at least that part of it involving small firms. Initiatives in the first of these, public intervention, implicitly or explicitly involve some form of subsidy, be it guarantees, tax benefits, grants, public loans or technical assistance, reduced regulatory hurdles, or favored treatment in the competition for public contracts. Any form of subsidy benefits the recipient and subsidies can be important in moving a firm to a position of self-sufficiency in obtaining capital, especially a start-up business. The thing that subsidies do not accomplish, however, is to alter the market in ways which might reduce or eliminate the need for subsidies for other new or small firms seeking capital in the future. Therefore, in addition to whatever subsidies the public may be willing to fund for aiding small firms, we should carefully study whether there are ways to increase the efficiency of the small firm capital market. I believe H.R. 660 would make an important contribution to increasing the efficiency of that market and the remainder of this testimony is directed to that issue.

The Nature of Inefficiencies in the Capital Market for Small Firms

Historically, bringing together directly savers who had investable funds with entrepreneurs in need of capital entailed high search costs. In addition, the two parties to such transactions had differing degrees of knowledge about the nature of risks involved (so-called information asymmetries) and vastly different objectives regarding default risk, maturity, size of the loan or investment, etc. These problems were greatly alleviated by the development of financial intermediaries such as banks, thrifts, and finance companies. Today, the market for capital for small firms is, predominantly, a financial intermediary loan market, especially a commercial bank loan market. The bank reduces search costs by specializing in gathering deposits and making loans, it reduces information asymmetries by developing expertise in credit evaluation, and it removes the impediments of differing objectives between saver and entrepreneur by issuing its own liabilities with characteristics which satisfy savers (depositors) and investing deposits in a diversified pool of loans tailored to meet the needs of borrowers. As such it is a market of negotiated transactions. Geographically, it is local. At the origination stage, banks are ideal vehicles for such a market. The bank and its branches have a local presence and orientation--nearly every community of any size has a bank or branch of which there are some 50,000nationwide. Each office has personnel who, if not authorized to give final approval to a loan, can serve to process the necessary

information, passing what is needed to the decision maker and the decision to the credit seeker. The bank specializes in such information processing thus reducing information asymmetries which would preclude direct investment in such loans by individual savers, is able to spread default risk by pooling the resources of many savers (depositors) and holding a diversified portfolio of C&I loans.

Despite these virtues, the market for capital for small firms is not an efficient market. While commercial banks are ideal originators of loans to small firms, they are ill-suited to be permanent investors in (warehousers) such loans. The reason for this is banks' high degree of risk aversion as investors in assets. This risk aversion stems both from the nature of bank liabilities (mostly short-term deposits) and from regulation. Bank risk aversion has intensified in recent years as a result of several factors, notably examiner reaction to loan losses and Congressional criticism and risk-weighted capital requirements. It is likely to intensify further as capital requirements are refined to include interest rate as well as default risk, and as deposit insurance premia become risk-weighted.

Less risk averse investors would be better suited as warehousers of C&I loans, but have far less capacity than banks to originate such loans, especially loans to small firms, largely because of the information asymmetries mentioned above. It is for these reasons that the market for business capital is inefficient.

For large firms this problem has been solved in a variety of ways: the public sale of securities; commercial paper; syndicated loans; and loan participation or sales. Unfortunately, these options do not exist where small firms are concerned or operate very poorly. In other areas of credit, the market's efficiency has been vastly improved by the development of secondary markets. This notably has been the case with regard to residential mortgage loans and, to a lesser extent, with credit card and lease receivables. In one form or another, a secondary market has been created by pooling the original loans and issuing to investors homogeneous instruments backed by the pool of heterogeneous loans. The challenge facing those who wish to improve the capital availability to small firms and/or to lower its cost, is to find ways to develop a secondary market for loans to small businesses.

A secondary market would enable commercial banks to continue to do what they are best suited to, originate and service loans to small business, but eliminate the necessity to warehouse such loans. The resulting liquidity which loans to small firms would acquire would enable banks to continually replenish funds with which to make additional loans. The pooling and securitization of these loans would result in diversification of default risk and greatly reduce search costs thus attracting permanent investors.

H.R.660 and an Efficient Small Firm Capital Market

Would enactment of H.R. 660 create an efficient market for capital for small firms? It seems clear to me that the provisions of the bill would help. They would increase the liquidity of certain types of loans to small business, enabling originators to sell these loans thus replenishing funds so that additional loans could be funded. Sale of the loans would eliminate the inhibition to making such loans caused by the risk-weighted capital requirements. The bill also would initiate a process of loan standardization which is essential to the development of an active secondary market. And, probably most important of all, the bill would provide a minimal risk asset through which a wide range of potential investors could gain familiarity with investments in C&I loan pools.

The development of a secondary market for loans to small firms will not be an easy task. Among

the foremost obstacles are default risk and lack of homogeneity of the underlying loans. With respect to default risk, creation of a secondary market by means of securitization of a widely diversified pool of loans to small business is a major step in reducing the risk associated with individual loans. It also enables managers of the pool to offer a homogeneous security to investors who, as noted earlier, are better situated to be permanent investors in loans to small firms than banks, but are not suited to originating such loans. Not only would such pools reduce default risk by virtue of diversification within each pool, but securities backed by such pools could be divided into various series or tranches representing various characteristics, including default risk characteristics, to suit the investment criteria of different types of investors. A virtue of the existing bill's provisions is that they will shorten the learning curve of acquainting investors with securities backed by loans to small firms and build relationships that can lead to sales of securities backed by a still wider range of loans to small firms than those covered in H.R. 660.

It also may be necessary to address the default risk problem by means of some form of credit enhancement despite the benefits of diversification. While the private marketplace may develop such a service, it seems likely, at least initially, that this would have to be provided by a public entity, as set forth in H.R. 660. Such credit enhancement need not be at the level of present SBA loan guarantee programs, i.e., 90 percent, but could be at much lower levels of exposure depending on what experience shows the market might demand to invest in any given type of conventional loan pool.

The problem of lack of homogeneity of underlying loans is the principal reason, of course, for securitizing a pool of loans rather than trying to develop an active secondary market for whole loans. But closely related, is the need to increase the degree to which certain characteristics of the loans are standardized. While the borrowers themselves cannot be made uniform, the credit standards and underwriting standards can be. Although such standardization could come about through agreement within the industry, given the number of banks in the country this seems unlikely and, even if it were to happen, would not come about quickly absent some powerful incentive. The best such incentive would be a purchaser of loans for a securitization pool who established minimum criteria for loans to be eligible for purchase such as provided for in H.R. 660. This has the virtue of providing an incentive (an available buyer) without forcing banks to alter their standards if they choose not to sell to the pool. The only other logical party for setting such standards would be a bank regulator. Unfortunately, we have three at the federal level alone, plus the 50 state regulators and, presumably, it would make adherence to such standards non-voluntary. The latter fact, of course, might enhance bank safety and soundness, but it might not enhance credit availability.

A second issue is whether the bill would interfere with private sector developments of a more far-reaching nature. Although I have heard such suggestions, it seems to me that the potential benefits outweigh the risks. As noted earlier in this statement, these benefits include the familiarization of investors with loans to small firms and the establishment of standards for loan eligibility, processes which seem likely to be accomplished more quickly and on a less haphazard basis as part of a government mandate. From the standpoint of the ultimate beneficiary, the small firm, an active government role at this stage seems only advantageous. It seems to be unlikely that the secondary market for mortgages would have progressed as rapidly as it did without government involvement and, ultimately, that did not prevent a wide range of private sector initiatives and innovations.

While H.R. 660 could advance significantly the development of a secondary market in loans to small firms, certain of its provisions limit its scope in ways which hinder solution of some major aspects of market inefficiency. Most important of these is the limitation to a secondary market "... for industrial mortgages" involving loans for "...land, facilities, buildings or equipment." As

important as it may be to provide a secondary market for these loans, one of the most pressing problems facing small business is access to capital to finance the expansion of working capital and work force. This is of particular importance in an economy becoming more service oriented where fixed assets are of less importance to many small firms. I believe H.R. 660 would be strengthened if the provisions allowed the new entity broader scope in both the types of loans purchased and the kinds of pools to be securitized and guaranteed.

Conclusions

H.R. 660 would make an important contribution to increasing the efficiency of the market for small firm capital. Its benefits could be further increased by broadening the scope of loans eligible for purchase and securitization.

Thank you.

OPENING STATEMENT OF JOHN J. LaFALCE, CHAIRMAN
COMMITTEE ON SMALL BUSINESS

HEARING ON CREDIT AVAILABILITY:
THE ROLE OF THE GOVERNMENT SPONSORED ENTERPRISE

May 6, 1993

Today the Committee continues its series of hearings into the availability of credit for small business.

As most of those present know, I have advocated the establishment of a new entity which I call "Velda Sue". This new entity would essentially securitize small business loans and match small business borrowers with investors with long-term funds such as insurance companies and pension funds.

Certainly this is not a new concept.

We have promoted loans to the housing industry in this manner for 50 years through the Federal National Mortgage Association or Fannie Mae and through the Federal Home Loan Mortgage Corporation or Freddie Mac. More recently we established a similar entity to make loans to agricultural businesses through the Federal Agricultural Mortgage Corporation or Farmer Mac.

Let me put housing and small business loans into perspective. As of March 31, 1993, the outstanding portfolio of SBA business loans was less than $16.3 billion; on the other hand, Fannie Mae alone provided over $600 billion for single family mortgage financing in the past five years. It is time to strike a better balance. The demand for additional small business lending is there. There is just no way to meet the need.

The existing SBA 7(a) loan guarantee program has been an invaluable resource, particularly as the credit crunch has hit small business so hard. I want to note for the record that last week the Small Business Administration closed its guaranteed loan window. It closed not for just a few days, but for the remainder of this fiscal year, unless and until a supplemental appropriation is enacted. Additional funding was in the President's stimulus package, but it was deleted in the Senate.

We must correct this situation immediately. Jobs and our economic recovery are at stake, as small businesses cannot provide employment unless they have access to capital.

As critical as this program is, however, continuing budget constraints will always preclude it from expanding sufficiently to meet the need. We must create new, innovative mechanisms to deal with the problem.

Today representatives of some existing GSEs, or Government Sponsored Enterprises, will present their experiences with government sponsored loan securitization programs - - - the advantages, the disadvantages, the costs and the possible government exposure.

We also have a witness from the Resolution Trust Corporation, which is securing capital by securitizing and marketing the assets it has acquired. Again I see a great similarity between the process the RTC is following and an approach I believe is feasible to increase small business financing.

It is somewhat ironic that these hearings are going on now. Much of the current credit crunch could have been avoided if we had had a viable secondary market for small business loans without an express Federal guarantee, as is provided in the SBA program. This is what Velda Sue is all about - - - a supplement for the SBA program, not a substitute. It would reduce the bulging demand for SBA financing. And it would do so without the need for additional Federal spending each time loan demand increased.

Today we are pleased to have with us Jayne J. Shontell, Senior Vice President-Financial and Information Services, Federal National Mortgage Association, John P. Gibbons, Vice President-Financial Research, Federal Home Loan Mortgage Corporation, Henry Edelman, President, Federal Agricultural Mortgage Corporation and Michael Jungman, Vice President-Capital Markets, Resolution Trust Corporation.

OPENING STATEMENT OF
CONGRESSMAN BILL ZELIFF (R-NH)
Small Business Committee
May 6, 1993

Mr. Chairman, thank you for calling today's hearing about the availability of bank credit to small businesses and the Secondary Market. It is always a pleasure to discuss this important issue with such a distinguished panel of witnesses.

I have been to many hearings on the lack of credit availability and without a doubt, the lack of credit continues to be a major concern for small businesses.

New Hampshire is still suffering from the effects of a very difficult economic environment. Although interest rates are low and banks have money, small businesses are still experiencing problems obtaining a loan. Some blame the bank examiners. Some blame Congress. Small businesses are drowning in a quagmire of federal regulation. Our small businesses need help.

What we need to do is create jobs and stimulate economic growth, starting by getting the government off the backs of American businesses.

New Hampshire's problem started in 1989, when the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) was passed. At the same time the New England economy experienced not just a cyclical decline, but a structural collapse.

Two of the regions most important economic engines, high-tech companies and defense contractors, suffered enormous hits. In light of spreading economic decline, the Northeast was over-invested in real estate.

FIRREA took effect in 1989, but New Hampshire was already deep in a recession. New Hampshire was hit harder than other regions of the country. Banks were caught holding non-performing loans as a result of the overextension of the real estate market.

In 1991 FDICIA prevented New Hampshire banks from using their capital to absorb their losses. The banking system in NH and New England underwent a structural collapse.

When the FDIC took over 5 of the 7 largest state banks and held 30% of New Hampshire's total banking assets, New Hampshire was burdened with an obvious problem.

We need to revisit past legislation which has gone too far in the name of safety and soundness. This includes FDICIA, FIRREA and even the Truth in Lending legislation. I am convinced we need to go beyond administrative tinkering.

I have been battling for reform since my first days here in Congress. Last month I held a hearing in Manchester, New Hampshire to hear testimony about the credit crunch problem in New Hampshire and about the need for a pro-growth agenda.

Of course, there is now some recovery in sight, loans are being slowly reinstituted, but the traditional post-deficit increase in bank credit is not happening this time. We need to investigate the cause of this problem. I submit, Mr. Chairman, that it has a lot to do with overregulation.

Mr. Chairman, small business is the foundation of this country. The credit crunch jeopardizes our ability to create jobs. I hope we can go beyond the excessive regulations and find a cure for this critical problem.

We are here today to discuss Secondary Markets and Government Sponsored Enterprises. While I support innovative ways to provide much needed credit for our credit starved small businesses, I think we need to move cautiously in this area. I have some reservations about GSE's like Velda Sue. We must not put government in direct competition with our small to medium size banks. What is the potential risk for the American taxpayer under such programs as Velda Sue?

I hope that you will address these issues during today's hearing so we can move closer to resolving the credit crunch problem and putting Americans back to work.

Thank you, Mr. Chairman.

Opening Statement
U.S. Rep. Jan Meyers (R-KS)
House Committee on Small Business
"Credit Availability and the Secondary Market"
May 6, 1993

Thank you, Mr. Chairman. I know that you and several of our colleagues on the Banking Committee are under time constraints because of a mark-up this morning, so I will be very brief.

Let me note that I remain very interested in discussing any proposal that makes it easier for small businesses to get the long- and short-term loans they need to thrive and expand. Whether it's by ensuring that the SBA's 7(a) loan guarantee program is fully funded, as several of our colleagues and I are trying to do through H.R. 1936, or whether its by removing barriers to the creation of an energetic secondary market, we in Congress must be attentive to the credit problems of small enterprises and innovative in our solutions.

I also remain concerned, however, about creating another government sponsored enterprise, especially with start-up costs of $300 million. I know that some argue that without a major player in a particular secondary market, standardization of underwriting standards, appraisals, and so on, can be a formidable barrier. Fannie Mae, Freddie Mac, Farmer Mac, and now the RTC certainly have performed well to create the standardization needed to securitize mortgage, farm, and now commercial loans, so the argument is seductive.

Still, I wonder if we aren't caught in the status quo here. I wonder if we aren't being too quick to say that since home mortgages and agricultural loans have been standardized and successfully securitized with GSE's, we need a GSE to securitize small business loans.

There may be other approaches. Senator D'Amato and Representative Baker have introduced legislation to remove statutory impediments that may be blocking the private sector from creating a secondary market. Perhaps we should try this approach first. If the private sector can accomplish the same goals, I think it would be preferable, if only to eliminate the need to put tax dollars at risk.

There may be other ideas, too, so I look forward to hearing from our witnesses today, what recommendations they have, and their thoughts on what the federal government can do to encourage private initiatives to organize a successful secondary market for non-guaranteed small business loans.

Thank you.

STATEMENT BY CONGRESSMAN JIM RAMSTAD
BEFORE THE HOUSE SMALL BUSINESS COMMITTEE
May 6, 1993

HEARING ON CREDIT AVAILABILITY A THE SECONDARY MARKET FOR SMALL BUSINESS LOANS

Mr. Chairman, I welcome the opportunity to discuss the critical issue of credit availability for small businesses with this morning's distinguished witnesses.

As a member of both the Small Business and Joint Economic Committees, I am keenly aware of the importance of small businesses to our economy -- and the problems they have faced in recent years in gaining access to credit.

The effect of tight credit is particularly hard on small businesses, which, unlike larger companies, do not have easy access to the debt and equity markets. Because they have no alternative financing avenue, when small businesses face tight credit, the result is devastating to the entire economy.

Small businesses, as we all know, are the real engine of job growth in our economy. In recent years, 85% of all new jobs in this country were created by small businesses, and in fact between 1988 and 1990, small businesses created all of the net new jobs in this country, according to the Small Business Administration (SBA).

Now that President Clinton has announced his proposal to impose the largest tax increase in history, the availability of credit for small businesses will be an even more urgent concern. As most economists agree, President Clinton's proposal to transfer $328 billion from the productive, private sector to the federal government will certainly constrict economic growth and reduce the availability of capital.

At a time of economic sluggishness, it is clear that enacting the largest tax increase in American history will have dire consequences for the jobs-producing, small business sector of our economy.

I have two informal advisory groups in my district -- a banking advisory group and a small business advisory group. In recent months, I could have combined the two meetings as both the small business owners and the bankers are concerned almost exclusively about the lack of credit, or the "credit crunch."

And while I believe that excessive bank regulations are largely responsible for the current credit crunch, I am very interested in facilitating the creation of a secondary market for small business loans.

At the same time, I am skeptical of legislation that would create a new government-sponsored enterprise (GSE) to manage this secondary market.

I have two primary concerns about GSEs. First, government funding will be necessary, at least initially, to create a new GSE. While I believe creating a secondary market for commercial loans is an important initiative, we must first explore a purely private sector version that can achieve the same goals much more efficiently. We simply cannot afford additional federal spending at a time when controlling the federal deficit must be our primary objective.

I am also concerned that government control over the apparatus that creates a secondary market for commercial loans will hinder innovation and growth in this new secondary

market. I found Ms. Shontell's testimony fascinating on this point.

She explained that Fannie Mae completed the transformation to complete private ownership in 1970, after paying the Treasury $216 million for its interest. Ms. Shontell also noted that until the early 1970s, Fannie Mae and other federal entities in the secondary mortgage market operated primarily by purchasing mortgages to redistribute the available mortgage from high capital to low capital areas.

Since the early 1970s, Fannie Mae has diversified its operations and today, in addition to redistributing funds, the secondary mortgage market links capital and mortgage markets through the sale of mortgage-backed securities to a variety of investors outside the traditional housing investment community.

I am very pleased to have true experts in the secondary markets for loans here this morning to discuss this issue with us. I am hopeful their insights will assist us in our pursuit to ease the small business credit crunch.

STATEMENT OF

JAYNE J. SHONTELL

SENIOR VICE PRESIDENT - FINANCIAL AND INFORMATION SERVICES

FANNIE MAE

BEFORE THE

COMMITTEE ON SMALL BUSINESS

UNITED STATES HOUSE OF REPRESENTATIVES

MAY 6, 1993

Mr. Chairman and Members of the Subcommittee, my name is Jayne Shontell. I am the Senior Vice President for Financial and Information Services at Fannie Mae. I appreciate this opportunity to discuss Fannie Mae's experience with the process of mortgage securitization, as it relates to the Subcommittee's study of legislation to create a secondary market for small business loans. A more efficient financial market for business and commercial loans, including commercial real estate loans, would benefit the nation. A more robust secondary market, providing liquidity and diversification of credit risk, might contribute to market efficiency. Although Fannie Mae's role has been exclusively in the housing market, our experience affords some lessons that should be helpful in your deliberations.

Fannie Mae (the Federal National Mortgage Association) was authorized by Congress and currently exists for the sole purpose of creating and supporting a secondary market for residential mortgages for low-, moderate-, and middle-income Americans. Fannie Mae and other secondary market conduits help make possible a wide range of mortgage lending, including lending specifically targeted on the needs of lower income and minority households and neighborhoods. We do this by providing the institutions that originate mortgages with a market in which to sell them. In so doing, the secondary market greatly expands the sources of funds for home mortgages, providing a reliable supply of credit at lower costs. Because of their large scale and nationwide operations, Fannie Mae and the Federal Home Loan Mortgage Corporation ("Freddie Mac") play particularly important roles in this arena.

Fannie Mae is the nation's largest investor in mortgages. During 1992, we served 2.9 million families and did $257 billion in total business. At the end of the first quarter of 1993, we held $159 billion in mortgages in our portfolio and had $457 billion in outstanding, guaranteed Mortgage-Backed Securities (MBS). Together, Fannie Mae's portfolio purchases and MBS finance about one-sixth of the outstanding residential mortgage debt in the United States.

The corporation's stock trades actively on the New York and other stock exchanges; it receives no federal appropriations, and its obligations are by law explicitly not guaranteed by the United States. Its funding comes instead from retained earnings, shareholder equity, and debt raised in world capital markets. Under the charter, the corporation's operations must be "fully self-supporting." In 1992, Fannie Mae earned $1.6 billion, retained $1.3 billion of that amount to increase capital to $7.6 billion, and paid $927 million in federal income taxes. For the first quarter of 1993, Fannie Mae earned $443.6 million and increased capital again to $8.0 billion.

In the 1980s, Fannie Mae served over eight million households. Continuing on this course, we will serve more than fifteen million families during the 1990s. Fannie Mae's financing activities help make housing more affordable to a wide range of low-, moderate-, and middle-income Americans, and a large share of our business serves those of modest means.

We also are playing an increasing role in financing rental housing with five or more units, which typically serves families with limited incomes. Fannie Mae's multifamily housing effort remains the largest multifamily program among all financial institutions in America. We now have more than $22 billion of multifamily loans in our portfolio and MBS.

In addition to these standard activities, we are undertaking a growing number of initiatives designed specifically to help lower income families afford decent shelter, to help revitalize older neighborhoods, and to make mortgage credit more readily available in minority and other underserved communities.

FANNIE MAE'S ROLE IN HOUSING FINANCE

Our relationship with the U.S. Government is, essentially, a compact. As a trade-off for the restriction on our dealing only in residential mortgages, the government has granted Fannie Mae a number of benefits which help support our mission to maintain a stable flow of funds to the mortgage sector and improve the efficiency of the housing market. Fannie Mae's innovation and marketing efforts, together with those of the Government National Mortgage Association ("Ginnie Mae") and Freddie Mac, were responsible for the development and acceptance of MBS and various other mortgage-related investment vehicles that are widely used in the market today.

Fannie Mae was created in 1938 as a subsidiary of the Reconstruction Finance Corporation to purchase mortgages insured by the newly formed Federal Housing Administration (FHA). In 1949, Fannie Mae also began purchasing VA mortgages. In 1954, Congress enacted the Fannie Mae Charter Act, which restructured Fannie Mae as a mixed-ownership (part government, part private) corporation to develop and support a national secondary market for residential mortgages. Then in 1968, legislation was passed permitting Fannie Mae to become completely privately owned and managed through the retirement of government-owned stock. Fannie Mae completed the transformation to private ownership in 1970, after paying the Treasury $216 million for its interest.

Fannie Mae is subject to regulation by both the Department of Housing and Urban Development and the Department of the Treasury. On October 28, 1992, the President signed into law Title XIII of P.L. 102-550, the "Federal Housing Enterprises Financial Safety and Soundness Act of 1992" which modernizes the regulatory oversight of Fannie Mae and Freddie Mac. The legislation creates a new regulator for Fannie Mae and Freddie Mac within HUD, the Office of Federal Housing Enterprise Oversight; sets tough new capital standards, including a minimum capital standard and a risk-based capital standard that will be developed through regulations by the new regulator; and sets ambitious housing goals for low- and moderate-income homebuyers and renters, families in central cities, and others with special housing needs. The legislation was the culmination of three years of legislative deliberations and numerous studies by the GAO, CBO, HUD, OMB and Treasury.

Our total commitment to housing and housing finance comes from the mission stated in our charter and the vision and values that we hold. In our 1992 annual report to our shareholders, Fannie Mae's Chairman, Jim Johnson, stated our commitment in this way:

> The Fannie Mae I see ahead will lead in all aspects of housing finance in America, never forgetting we exist to serve the people of the United States and always mindful we represent interests of our shareholders whose capital makes

> our unique franchise work. We will always be faithful to the purposes of Fannie Mae's franchise to provide stability and liquidity to the mortgage finance system at all times, and we will keep this faith because we know how indispensable we have become to the housing finance system and to those families who cannot afford decent housing without our help. It is a great trust placed in us that we will always honor and respect.

We have recently been given additional challenges to meet risk-based capital standards and housing goals yet to be formulated by different parts of HUD.

In the twenty five years since Fannie Mae became a private company, we have developed a capital base of more than $8 billion to support our housing activities. We currently meet the minimum capital requirements of the new law. The new risk-based capital standard will be dynamic, calculated quarterly, and capable of substantial movements during a year.

With regard to the new housing goals, while HUD will establish interim goals in the near future, we do not expect permanent goals until sometime next year. We are committed to attaining those housing goals, whatever they may be.

FANNIE MAE OPERATIONS

Fannie Mae's Charter Act authorizes it to act both as a portfolio investor in residential mortgages and as an issuer and guarantor of mortgage-backed securities. In its role as a portfolio investor, Fannie Mae purchases 1-4 family and multifamily FHA, VA and conventional mortgages. It pioneered the development of a national secondary market for second mortgages, condominium mortgages, and adjustable-rate mortgages (ARMs). Fannie Mae also has provided secondary market support to rehabilitation loans and to federal housing subsidy programs by purchasing, at market prices, loans originated under those programs.

Fannie Mae's mortgage purchases are based on its issuance of commitments. Through its standard "window programs", Fannie Mae provides lenders with a contract indicating that Fannie Mae will purchase specific loans within the stated time period. With most commitments, lenders can lock in rates. Fannie Mae will also consider the purchase of a wide variety of loans that meet sound underwriting standards on the basis of negotiated transactions. The negotiating program is used to provide flexibility in marketing new products (such as ARMs), and making commitments on large blocks of mortgages, and in pooling mortgages to back MBS. Fannie Mae earns fee income on its commitments, which varies depending on the delivery term of the commitment and the type and term of the mortgage being delivered.

During the first 13 years of its existence as a private corporation, Fannie Mae provided liquidity to the mortgage market almost entirely by purchasing mortgages for its own portfolio. In 1981, Fannie Mae expanded its services to include a successful mortgage-backed securities program,

which not only broadens the funding sources for the mortgage market, but provides Fannie Mae with a source of income unaffected by the impact of interest rate fluctuations.

Fannie Mae issues guaranteed MBS backed by loans from its own portfolio, as well as lender-pooled loans which meet its normal purchase requirements. The structure of Fannie Mae's mortgage securities program encompasses a broad range of products designed to meet the needs of different investors, including mortgage pass-through securities, and multiclass securities known as Real Estate Mortgage Investment Conduits ("REMICs").

Most of Fannie Mae's MBS are backed by fixed-rate conventional mortgages, but we have also issued pools collateralized by adjustable rate mortgages and multifamily mortgages. In all cases, Fannie Mae guarantees the timely payment of principal and interest on its MBS. This relieves MBS buyers of the risk that the underlying mortgages will default or will make payments late, and relieves them of the need to know some of the specific characteristics of the mortgages that could affect those risks. In addition to being freed from default and slow payment risks, an advantage for the investor is that the MBS is a homogeneous and easily-traded investment.

MBS issues can be sold through two channels. The first, referred to as a "swap" transaction, occurs when a thrift or mortgage banker exchanges a pool of mortgages for an MBS issued by the corporation. The second channel occurs when Fannie Mae pools mortgages from its own portfolio and sells the MBS through a public offering or private placement.

The MBS program generates fee income for Fannie Mae. Fannie Mae earns a guaranty fee from its MBS program, which is determined according to the responsibility assumed by the lender, the performance of the lender, and the anticipated performance of the mortgage loan. Fannie Mae earns its MBS guaranty fee so long as the security is outstanding.

THE MORTGAGE SECURITIZATION REVOLUTION

Until the early 1970s, Fannie Mae and other federal entities in the secondary mortgage market operated primarily by purchasing mortgages to redistribute the available mortgage money from high capital to low capital areas. Today, in addition to redistributing funds, the secondary mortgage market links capital and mortgage markets through the sale of mortgage-backed securities to a variety of investors outside the traditional housing investment community. Starting from virtually zero in the mid-1970s, by 1992, roughly 48 percent of the $2.9 trillion of single-family mortgages had been securitized.

Mortgage-backed securities have broad investor appeal. A key reason investors are attracted to MBS is because Fannie Mae guarantees timely payment of interest and principal on the securities. By purchasing mortgage-backed securities, investors can supply funds to the mortgage market without concern about the credit risk associated with the mortgages supporting mortgage-backed securities. The wide appeal of mortgage-backed securities attracts more funds to the mortgage market, thereby broadening the availability and lowering the cost of funds available for housing.

Fannie Mae, Ginnie Mae and Freddie Mac play a critical role in the mortgage-backed securities market, and among the reasons I am representing the company today is my background in securitization. I spent six years at Freddie Mac in the early days of their Participation Certificate or "PC" program, and I have been at Fannie Mae for the full 11 years of our mortgage-backed securities program. I also was personally responsible for setting up Fannie Mae's REMIC program. Consequently, I have significant experience in creating and growing asset-backed securities programs.

Fannie Mae has programs to securitize both single-family and multifamily mortgage loans, and its multifamily loans seem most analogous to the commercial assets under discussion today. Multifamily and commercial loans present more challenges for efficient secondary market trading because of several factors. Frequently, there is not consistent, relevant historical data on the performance of such commercial loans; documents and loan structures are not standardized; and there is no breadth of nationwide credit experience for these loans.

For these reasons, commercial loans are difficult to securitize, but the process can work. Fannie Mae's experience points to four hallmarks of successful securitization programs.

First, successful programs separate credit risk taking from the cash flow marketing. These are two very different risks entailed in asset securitization, and different expertise is required in dealing with each. For example, in the housing arena, Fannie Mae deals with the credit risk. We develop and monitor underwriting standards used by those customers who sell loans to us. As our experience grows, we refine those standards. We have an incentive to take the best practices and institutionalize them. The second part of the process -- marketing the cash flows -- is Wall Street's bailiwick. Wall Street has the incentive to be creative, and to develop proprietary products. Securitization permits each party to focus on what it does best, bringing the two together in a very effective partnership. The market for mortgage-backed securities has therefore grown, both because of homogenization of credit underwriting and financial creativity in marketing the securities.

A second hallmark of successful securitization is centralizing securities issuance. This allows for high liquidity and continuous market presence. It translates into investor familiarity with a product, and confidence with a variety of players at every level of underwriting, trading, and selling the securities.

The third factor is that successful programs build wide experience. Centralization, in the case of Fannie Mae, has led to unrivaled expertise in mortgage investing. It has enabled us to gather data on millions of transactions across all regions over a continuous period of many years. Fannie Mae's high volume experience has made us much more efficient. We have, and our investors have, a high level of confidence in our ability to evaluate and control risk based on this wide experience.

The fourth critical factor in a successful securitization program is homogenizing diverse assets. Standardized assets are helpful, but not critical, to developing an efficient securitized secondary

market. Both Fannie Mae's experiences with adjustable-rate mortgages and multifamily loans were analogous to commercial lending in this respect. In each case, though the underlying loans were diverse, with distinctive credit risks, documentation, and cash flow characteristics, Fannie Mae was able to issue almost $93 billion in single-family ARM MBS and a total of $12.9 billion in multifamily MBS. The critical factor was Fannie Mae's ability to assess the differences, group like products and features together, standardize where that made sense, and create standards to help the market deal with differences.

CONCLUSION

An effective securitized secondary market depends on two crucial ingredients. The first is a means to concentrate credit risk, so an issuer benefits from risk diversification across geographic boundaries and a large volume of transactions. Second, to assure investors of the integrity of the securities, the issuer must have adequate capital to protect against its risks and support the credit guarantees. A large scale national presence enables the issuer to develop operating economies which lower costs and to benefit from risk diversification -- which in turn allows operating with less capital to protect against lower risk.

Fannie Mae would be pleased to work with the Subcommittee as it continues to assess how the federal government could best support renewed strength in the commercial lending sector.

Testimony

of

John P. Gibbons
Vice President, Financial Research
Federal Home Loan Mortgage Corporation

before the

Committee on Small Business
United States House of Representatives

May 6, 1993

Good morning Mr. Chairman and members of the Committee on Small Business. My name is John Gibbons. I am the Vice President of Financial Research for the Federal Home Loan Mortgage Corporation, or Freddie Mac. It is a pleasure to appear before the Committee today to discuss the success of the residential secondary market, particularly as it relates to the proposed development of a secondary market for small business loans. My prepared statement describes the origin and role of Freddie Mac in the housing finance system and addresses the Committee's specific questions regarding securitization and its application to small business loans.

Reasons Behind a Residential Secondary Mortgage Market

Freddie Mac was created in 1970 to develop a secondary market for investment quality conventional loans. At that time, there was a geographic mismatch between the supply and demand for residential mortgage funds. Fast growing regions of the country were experiencing excess demand for mortgage credit as young baby-boomers formed households. In older, more settled regions of the country, there was an excess supply of household savings and low mortgage demand.

In addition to geographic imbalances, there was a problem of institutional mismatch, or disintermediation. Thrifts -- which had been the traditional suppliers of mortgage credit -- were less able to provide mortgage funds as depositors withdrew funds to reinvest

them at higher yields in different funds or institutions. At that time, there was no financial intermediary to channel household savings kept in these different funds and institutions back to conventional mortgage markets.

To deal with geographic and institutional imbalances, thrifts bought and sold mortgages among themselves. However, the mortgage market was too illiquid to adequately correct the mismatch in mortgage credit supply and demand. Congress recognized the negative implications of this problem and established Freddie Mac under the Federal Home Loan Bank System in 1970 to create a liquid market for conventional loans and thus to increase the availability of mortgage credit. At the same time, Fannie Mae and Ginnie Mae, the other housing secondary market entities, were creating liquid markets for loans insured by the Federal Housing Administration and the Veterans' Administration.

Thus, the secondary market was created to help make savings generated by households available to mortgage borrowers regardless of geographic or institutional imbalances. The entities provide the necessary intermediation between savers and home buyers, tapping into funds that had previously been unaccessible for housing. By making the delivery of mortgage credit more efficient, the secondary mortgage market lowered mortgage rates, especially in high-demand areas.

<u>Freddie Mac Capitalization</u>

Freddie Mac was initially capitalized by $100 million from the purchase of common stock by the Federal Home Loan Banks. This was its only source of externally generated capital until 1988.

Throughout the 1970s and mid-1980s, Freddie Mac relied on retained earnings to fund its growth. In June 1980 Freddie Mac paid a dividend of $50 million to the Federal Home Loan Banks, which in turn passed it through to member thrift institutions. Shareholders' equity at that time had grown from the initial $100 million to $221 million. In December 1984 Freddie Mac paid a stock dividend of 15 million shares of non-voting, participating, preferred stock (with a par value of $10 per share) to the Federal Home Loan Banks. They, in turn, devolved the preferred stock to member thrift institutions. Ownership of Freddie Mac stock was restricted to savings institutions who were members of the Federal Home Loan Bank System. Shareholders' equity at that time was $606 million dollars.

In August 1989 the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) converted Freddie Mac's non-voting preferred stock to voting common stock and provided Freddie Mac with a Board of Directors of which 13 are shareholder elected and

five are presidentially appointed to represent specified industry groups. Thrifts realized a gain of several billion dollars in this transaction. FIRREA completed Freddie Mac's transition from a government controlled agency to a corporation whose stock is publicly traded and the majority of the Board of Directors is shareholder elected.

In 1990 Freddie Mac's Board of Directors severed ties to the Federal Home Loan Bank system by redeeming the $100 million in stock owned by the Banks. All but $105 million of Freddie Mac's $2.1 billion in capital was generated internally through retained earnings. In anticipation of the new capital requirements of Title XIII of the Housing and Community Development Act of 1992, Freddie Mac issued $562.5 million in perpetual, fixed-rate, preferred stock in April, 1992. Shareholders' equity at the end of 1992 was $3.6 billion.

In summary, Freddie Mac was initially capitalized through the Federal Home Loan Banks, and that contribution proved extremely profitable to the thrift industry. Since privatization, shareholders have earned returns, on average, above those of the Standard and Poor's 500. In addition, Freddie Mac's 22 straight years of profitability have allowed it to fund dramatic growth in its business and fulfill its congressional mission, while at the same time minimizing risk to U.S. taxpayers.

How the Secondary Market Works

The secondary mortgage market serves borrowers by linking primary mortgage markets with capital markets. Mortgage originators sell mortgages into the secondary market and receive funds that can be used to originate more loans. For the most part this process is invisible to borrowers. Homeowners continue to make monthly payments to mortgage lenders that service the loans for Freddie Mac or for the other institutions.

Secondary market entities finance mortgage purchases in two ways. The first way is to hold the mortgages in portfolio and to finance them by issuing debt. To the extent that the investment yield on the mortgages exceeds the cost of financing the debt, the secondary market entity makes money. Significant changes in interest rates can make this financing approach risky, however. If rates fall mortgages will prepay, leaving the secondary market entity with funds that must be reinvested in mortgages with lower yields. This reduces revenue if the debt cannot be called. If rates rise, the expected life of the mortgages may extend beyond the maturity of the debt. This will cause the entity to refinance the debt at higher costs, again reducing revenues.

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The second option, and the method by which 90 to 95 percent of Freddie Mac's loans are financed, is to group these mortgages into large pools and to sell them to investors in the form of a mortgage-backed security called a mortgage participation certificate (PC). Securitization of the underlying mortgages avoids interest rate risk because the maturity of the mortgage and the financing mechanism match.

Lenders pay management and guarantee fees to Freddie Mac for supervising the mortgage servicing process and ensuring the timely pass-through of principal and interest payments to investors. Freddie Mac guarantees the full payment of principal to investors in the event that mortgages prepay or default.

Mortgage-backed securities are valued by investors for their low-risk and high returns. Institutional investors hold nearly 98 percent of mortgage securities, with individuals holding the remaining portion. The largest investors are banks, which hold approximately 24 percent, followed by life insurance companies (16.2 percent), pension funds (12.6 percent), savings and loans (11 percent), and mutual funds (7.2 percent). Other holders of PCs are Federal Home Loan Banks, credit unions, individuals and government sponsored housing enterprises.

In recent years the basic PC security has become a building block for more sophisticated derivative securities. Over 90 percent of

newly issued Freddie Mac PCs were resecuritized into real estate mortgage investment conduits (REMICs) in 1992. In a REMIC, cash flows from many PCs are divided into classes that differ by cash flow characteristics. By tailoring the risk and return characteristics of derivative securities to meet the different needs of institutional investors, Freddie Mac broadens the investor market for mortgages, thus increasing the liquidity of the secondary mortgage market. This ultimately result in lower mortgage rates for consumers.

Federal Exemptions and Advantages to Secondary Mortgage Markets

To enhance the efficiency of the mortgage delivery system, Freddie Mac and Fannie Mae are exempt from certain federal and state securities laws. Briefly, they include an exemption from registration of securities with the Securities and Exchange Commission to the same extent as Treasury securities, and exemption from "Blue Sky" registration of securities with state securities commissions.

Freddie Mac also has a number of other advantages provided by law that increase the marketability of its securities and contribute to our classification as a government sponsored entity. These include a potential line of credit of $2.25 billion at the U.S. Treasury; eligibility of our securities as lawful investments for all entities created pursuant to federal laws or the laws of many

states; eligibility of securities for collateral for fiduciary trust and public funds under the control of the United States; and eligibility of our securities to be purchased by the Federal Reserve Banks and issued and traded through the Federal Reserve Bank's book entry system. While Freddie Mac is subject to federal income tax, it is exempt from state and local income taxes. In 1991, Freddie Mac paid over $400 million in federal taxes, and will pay an estimated $500 million in taxes for 1992.

These advantages allow Freddie Mac to issue securities more efficiently and cheaply, and broaden its investor base. The net results are a continuous flow of mortgage credit and a reduction in mortgage rates to home borrowers.

Credit Risk

Freddie Mac's ability to understand and price the credit risk of the mortgages underlying its securities is crucial to the success of the secondary mortgage market. These risks are significantly minimized by a number of factors. First, mortgage pools are composed of many small, homogeneous mortgages. By law, Freddie Mac may not purchase mortgages that exceed the current conforming loan limit of $203,150. In addition, all loans must either have a loan-to-value (LTV) ratio of at most 80 percent, or carry private

mortgage insurance or some other form of credit enhancement. Finally, all mortgages purchased must be of investment quality.

By purchasing loans from all regions of the country, Freddie Mac significantly reduces its exposure to credit risk. Although one region of the country may experience credit problems, for example Texas in the early 1980s, all regions are unlikely to experience distress simultaneously. By diversifying across regions, it's unlikely a downturn in any one area would severely strain the financial resources or capital base of the company.

Loans sold to the secondary market entities must meet rigorous underwriting requirements that are the standards for the industry. For single-family mortgages, sellers are required to collect and verify a large amount of borrower information, such as employment, credit and income information, and property information, including its appraised value and whether it is an owner-occupied or investment property. Freddie Mac's underwriting guidelines are detailed in its "Sellers' and Servicers' Guide" (the "Guide").

Research shows that the loan-to-value ratio of the mortgage, a borrower's payment-to-income ratio, and debt-service-to-income ratios explain most of the variation in defaults for residential mortgages. These standard measurements of risk imply that the riskiness of mortgage-backed securities can be assessed and controlled with relatively little information.

Finally, Freddie Mac also minimizes credit risk by establishing eligibility requirements for seller-servicers with whom it does business. The "Sellers' and Servicers' Guide" acts as a contract between Freddie Mac and the seller-servicer. The seller-servicer must meet net worth requirements and has the responsibility for assuring that mortgages originated and sold to Freddie Mac meet with the underwriting guidelines. If a loan ultimately defaults, Freddie Mac has the right to examine the original application file to ascertain whether the lender complied with the underwriting guidelines.

Successes and Difficulties of the Secondary Mortgage Market

Freddie Mac has succeeded in creating liquidity in mortgage markets while remaining financially sound. There are several reasons for this success. The first reason is the ability to reasonably assess risk because of the fairly uniform nature of the size, maturity, and terms of conventional single-family, owner-occupied mortgages. The homogeneity of the underlying mortgage collateral allows standardization of underwriting and lower administrative costs.

A second reason is that the collateral value of single-family mortgage loans is relatively easy to measure. As mentioned, most variation in defaults can be explained using the loan-to-value, payment-to-income, and debt-service-to-income ratios. In addition, data to measure these risk variables tend to be reliable and easy

to verify. Moreover, because the majority of mortgages are for owner-occupied housing, borrowers have incentives, over and above protecting their equity investments, not to default.

Finally, there has never been a shortage of high-quality mortgages to purchase. Freddie Mac was established to correct regional and institutional imbalances in the supply and demand for mortgage credit. Demand for the underlying product, housing, has remained strong.

Freddie Mac's experience with multifamily mortgages has not been as successful as its single-family program, however. Measuring and quantifying the risk of these mortgages is much more difficult than for single-family loans. In terms of credit risk, mortgages for multifamily units are closer to small business loans than are single-family mortgages. Multifamily mortgages are less homogenous because of the significant differences in the location and age of the underlying properties, income-earning potential, expenses and property maintenance requirements, as well as characteristics of the owner and neighborhood. Estimation of variables such as earning potential, management expertise and business climate add a complex dimension to the estimation of risk associated with small business loans, which is for the most part absent from that of single-family mortgages.

Because of the higher risk of these loans, Freddie Mac requires lenders to provide information on vacancy rates and the stability of the expected rental income flows on multifamily properties. To cover these additional risks, management and guarantee fees on multifamily properties are substantially higher than the fees earned on single-family mortgages. Lenders need to know their local markets -- the needs of borrowers and of renters. Freddie Mac believes there are lessons from our multifamily program that would be helpful to the development of a secondary market for small business loans.

Small Business Markets

Small business loans -- like multifamily properties -- differ from residential real estate primarily in their heterogeneity. Underwriting small business loans requires knowledge of both the nature of the business, local market conditions and management expertise. The ability of the residential secondary mortgage market to take credit risk without localized underwriting is therefore not easy to replicate for small business loans.

Portfolio diversity also differs between small business loans and residential real estate loans. The residential secondary market reduces its risk exposure by holding a geographically diverse portfolio. In business lending, it is probably also necessary to

diversify the types of businesses in the portfolio, to avoid risk of a downturn in a certain industry. This adds another dimension to the problem.

In addition, the question of what happens in the case of default of the business must be considered. In single-family homes, the only expertise required is to prepare and sell the unit. When a small business defaults, someone has to manage the business until it can be sold. Failure to accomplish this effectively could result in rapid deterioration of the business and hence its value. Severities from defaults are likely to be much higher than for single-family homes.

The most important difference between securitizing residential mortgages and small business loans is the ability to take on the credit risk without localized underwriting. Freddie Mac has been able to do this for residential mortgages for the reasons described above. This will be more of a challenge for an agency securitizing small business loans, where specific, detailed knowledge of the business and local economic climate are more critical. One possibility is to confine the secondary market to providing liquidity while leaving the credit risk with the originator through the use of full or substantial recourse loans.

The existence of GSEs provide both benefits and costs. The benefits are that they can raise capital relatively cheaply and can

help promote standardization in the market. The disadvantage is that they can become a fiscal burden if they do not address the underlying problems causing perceived credit shortages. GSEs can help provide liquidity, but they cannot counteract recessionary forces lowering demand in the primary credit market.

Conclusions

To develop a successful secondary market for securitizing small business loans, it is necessary to understand the fundamental problem in the primary credit market. The residential secondary mortgage market was created to correct market inefficiencies in the supply and demand of mortgage credit. It was not established to stimulate demand for housing.

Inferring the likelihood of success for a small business secondary market entity from that of Freddie Mac and Fannie Mae must therefore be done with care. It is true that there is much to learn from our experience. The principal lesson is that government sponsored housing enterprises have been successful because they addressed the underlying problems in an effective manner, and carefully managed their credit risk. A major hurdle for a small business secondary market agency will be to understand and control the risks associated with guaranteeing these loans. Repeating this

success for small business lending is a challenge that should be examined on its own merits.

Institutions such as Freddie Mac, Fannie Mae, and the proposed agency for small business loans need risk-based capital requirements appropriate to the potential risks of the markets in which they are involved. One of the significant challenges confronting a small business government sponsored enterprise will be in defining these requirements for small business loans. The capital required to do this safely is likely to be much different than for residential secondary market entities.

Mr. Chairman, this concludes my prepared remarks. I would be happy to answer any questions at this time.

FEDERAL AGRICULTURAL MORTGAGE CORPORATION
Farmer Mac

Statement of
Henry D. Edelman
President and Chief Executive Officer
before the
Committee on Small Business
United States House of Representatives
May 6, 1993

Mr. Chairman, members of the Committee, I am Henry D. Edelman, President and CEO of Farmer Mac. On behalf of the Board of Directors and management of Farmer Mac, I want to express our appreciation for this opportunity to appear before your Committee to provide information relating to Farmer Mac's experience in developing and implementing the agricultural real estate mortgage secondary market.

Farmer Mac in Brief

The Farmer Mac program was created by the Agricultural Credit Act of 1987 (12 U.S.C. 2279aa) (the "Act") "to provide for a secondary marketing arrangement for agricultural real estate mortgages. . . to increase the availability of long term credit to farmers and ranchers at stable interest rates. . . to enhance the ability of individuals in small rural communities to obtain financing for moderately-priced homes. . . to provide greater liquidity and lending capacity to [the lenders]." The basic parameters of the program were set forth in the Act. The Farmer Mac Interim Board of Directors was instructed to capitalize the company and organize the election of a Permanent Board of Directors. The Act further instructed the Permanent Board of Directors to develop standards for credit underwriting, security appraisal and loan diversification and submit them to Congress for review prior to implementation. These processes were completed by late 1989 and the Farmer Mac Securities Guide (the "Securities Guide") was issued in January 1990, setting forth the full details of the program.

Under the terms of the program as specified in the Act, an eligible borrower obtains a "qualified loan" from an "originator" participating in the secondary market for agricultural real estate loans, that either is a "certified facility" (also referred to as a "pooler") or sells the loan to such an entity. The certified facility aggregates qualified loans it originates or purchases into a "pool" that meets Farmer Mac's diversification standards and uses the pool as collateral for the issuance of Farmer Mac guaranteed mortgage-backed securities.

To be eligible for the Farmer Mac guarantee, the mortgage-backed securities must be supported by a statutory 10% minimum cash reserve or subordinated class of

securities and the pool must pass Farmer Mac's "stress test" for performance in a computer simulated "worst case" economic scenario. Farmer Mac is authorized to charge an annual guarantee fee of no more than 0.5% of the remaining principal balance of the pool. Before any claim can be made by the guaranteed security holders under the Farmer Mac guarantee, the cash reserve or subordinated class of securities, together with reserves required to be set aside by Farmer Mac from guarantee fees it collected, must first be "exhausted." As a last resort, Farmer Mac is authorized to draw upon a $1.5 billion line of credit with the Department of the Treasury, if necessary to make payments on its guarantees. Subsequent legislation in 1991 established minimum capital standards for Farmer Mac, to reduce further the risk of its use of the Treasury line.

During 1990, at the request of the U.S. Department of Agriculture, Farmer Mac assisted in the development of a legislative initiative to expand its secondary market program to include the guaranteed portions of Farmers Home Administration (FmHA) guaranteed loans. Congress enacted the authority for the new program, now known as "Farmer Mac II," as part of the 1990 Farm Bill.

During 1991, Farmer Mac developed its "Linked Portfolio Strategy" (LPS) in response to the disparity between the notional value of commonly structured agricultural mortgages and mortgage-backed security pricing indications from the capital markets. This disparity was due to the lack of historical data on the performance of agricultural mortgages generally and those that qualified for the Farmer Mac program in particular. Under LPS, senior securities guaranteed by Farmer Mac are purchased by a Farmer Mac subsidiary and funded with Farmer Mac straight debt securities issued in the capital markets. These transactions result in no change in Farmer Mac's credit exposure on the senior securities, and the interest rate exposure is offset by "yield maintenance" (make-whole) prepayment terms on either the mortgages or the senior securities and by the issuance of callable debt by Farmer Mac, and in some instances a combination of the two. The net result is the generation of matched assets and liabilities requiring only minimal active management. Legislation confirming Farmer Mac's authority to conduct LPS transactions was enacted by Congress in the end of November of 1991.

By the end of 1992, the volume of securities guaranteed by Farmer Mac totalled approximately $613 million under the original program (now known as "Farmer Mac I") and approximately $32 million under the Farmer Mac II program. More important than volume, however, has been the efficiency of those transactions. With Farmer Mac debt priced only a few basis points higher than the debt of the other Government Sponsored Enterprises (GSEs) in those transactions, an attractive funding base was clearly established. The use of LPS resulted in significant savings in securitization over the sale of agricultural mortgage-backed securities, on the order of 0.90% on an all-in cost basis. These accomplishments led to the commencement of two new agricultural loan pooling

initiatives in the beginning of 1993, making highly competitive long term fixed rate loans available to agricultural borrowers across the country.

Specific Points of Inquiry Regarding Farmer Mac's Start-up Operation

A detailed description of Farmer Mac's experiences and prospects and a review of the farm lending environment during recent years are set forth in Appendix I and Appendix II of this testimony. At this point, I would like to address a number of points of inquiry regarding certain aspects of Farmer Mac's operations and the relevance of Farmer Mac's experience to the consideration by this Committee of legislation to authorize a secondary market for small business loans.

* *What is Farmer Mac's role, as a GSE, in establishing the secondary market for agricultural loans?*

Farmer Mac's role is to organize and stimulate the establishment of the secondary market under circumstances when other private sector entities have failed to step into the business due to perceptions of excessive risks and uncertain profit potential. GSE status provided Farmer Mac with sufficient credibility in the marketplace that it has not only been able to effectively organize and structure the agricultural secondary market, but also to enter the capital markets with its first issues at pricing levels comparable to the much more established residential housing secondary market agencies. Without GSE status, the Farmer Mac debt and mortgage-back securities could not have been issued as competitively as they were and as a result it is unlikely that any of the four pooling transactions we completed would have taken place.

* *What key circumstances did Farmer Mac face in getting started?*

Unlike the other GSEs, the bulk of Farmer Mac's experience to date has been generated in the process of launching the secondary market for these essentially commercial mortgages.

<u>Market Dynamics</u>

<u>Borrowers</u> range from the assisted credits who participate in the FmHA guaranteed loan program to large corporate farming operations. Quite aside from the range of their farming skills -- the general view is that the weakest were taken out of play during the agricultural downturn of the mid-1980's -- the borrowers represent a wide spectrum of financial acumen. Many of the smaller operators depend on their lenders

for financial advice, while some of the larger corporate farms have their own Chief Financial Officers. Their sensitivity to interest rates varies considerably, as do their interest rate risk avoidance strategies.

Many borrowers tend to look for troughs in rates based on recognized markers, such as "single-digit rates" or (more recently) "rates below 9%." Finally, the financing needs of producers of different commodities vary widely. Row crop farmers need to finance mainly non-depreciating real estate. At the other end of the spectrum, livestock producers with confinement facilities need to finance real estate that depreciates fairly rapidly, sometimes with a ten-year useful economic life. In short, some agricultural borrowers behave like residential mortgage borrowers, and others like corporate finance executives, but they all exhibit the diverse needs of commercial borrowers from the middle market down to small businesses. Coupled with the lack of reliable historical data on defaults and prepayments, the range of preferences of the borrowers creates an ongoing product design challenge. Still, the total market size, somewhere in the range from $60-80 billion with 10% annual turnover, would appear more than able to sustain a secondary market.

Rural housing mortgage securitization opportunities are undoubtedly several times greater, but the securitization of those loans, in areas typically outside the ambit of Fannie Mae and Freddie Mac, has been even more elusive. This is partly due to the community size limit (population 2,500 or less) placed on Farmer Mac and on the Farm Credit System. Other contributing factors are competitive pressure created by the existing residential mortgage secondary markets and the short-term maturity traditions established by many lenders, who are unwilling to take long term property value risks on residential properties in small communities.

Primary Lenders ("Originators" in the Farmer Mac program) include mortgage brokers, small community banks, medium-sized intrastate banks, regional banks, several national banks, insurance companies, the institutions of the Farm Credit System, growers' cooperatives, credit unions, livestock production integrators, farm tractor companies, and chemical companies, not to mention a silo manufacturer. The marketing motivations of these participants vary widely. Some see agricultural real estate lending as a growing opportunity into which they can profitably expand. For some, particularly the Farm Credit System institutions, agricultural lending is their only line of business. Others see it as a shrinking sideline. Many are severely constrained by their regulators even to the point where they have withdrawn from the market and are liquidating their portfolios. There are some who have withdrawn to higher ground, making only loans above $1 million. In certain areas of the country, agricultural real estate loans are a low-profit loss leader, maintained primarily to ensure access to more profitable short-term operating loans and equipment loans.

The primary lenders' financial motivations also vary considerably. For a variety of reasons, certain lenders are experiencing a period of excess liquidity. Many of these highly liquid lenders have no experience in the residential mortgage secondary markets, and find it hard to understand the basic reasons for selling loans in the current economic environment. Other lenders, particularly in the insurance industry, are under rating agency pressure to move away from commercial real estate loans, of which agricultural loans are a subset. Some have access to deposit funding. Farm Credit System institutions have access to the same capital markets sources as Farmer Mac, albeit to fund portfolio lending operations. In short, the primary lenders are almost as diverse as the borrowers.

The loan aggregators ("Poolers" in the Farmer Mac program) carry forward some of the attributes of the primary lenders to the extent they serve those functions. Insurance companies, Farm Credit district banks, and regional commercial banks fit this description. Some insurance companies are direct lenders, others operate on bank referrals, others actually maintain a network of affiliated bank lenders. Farm Credit district banks once aggregated loans and supported them with liabilities issued on a systemwide basis through the Farm Credit Funding Corporation. The district banks are now moving the loans downstream to the associations, who were always the primary lenders, but many district banks are retaining the interest rate risk management function. While the insurance companies and commercial banks have long histories of involvement in the residential mortgage secondary markets and several are major participants, it is usually through personnel not connected to their agricultural lending operations. Few management performance incentives are in place to encourage the creation of fee-based profit centers in many of those institutions. Certain Farm Credit institutions are suspicious of Farmer Mac and the consequences of securitization in the context of all the pressures placed on them following the agricultural economic downturn of the mid-1980's, while others are excited at the new competitive opportunity.

All in all, even when the interest rate cycle has been favorable, Farmer Mac has been trying for several years to securitize loans in a singularly diverse and structurally resistant environment. The sustaining motives have been the Congressionally mandated purpose of bringing more stable and competitively priced loan terms to borrowers and the conviction that what has worked for the residential mortgage markets will also work for the agricultural and rural housing markets. In recent months, after many years of effort, those motivations are looking more justified than ever, based on new programs that utilize the economics of recent Farmer Mac LPS transactions to establish new competitive loan products.

• *How are Farmer Mac loan issues securitized?*

Farmer Mac loan issues are generally securitized through a "senior/subordinated" structure. Qualified Loans are made by Originators (including Poolers acting directly as lenders) and sold to Poolers. Poolers form pools, which they deliver to a Trustee designated by Farmer Mac. At least two classes of securities are issued, senior and subordinated, both backed by the loan pool.

A subordinated class, subject to the first risk of credit loss on all loans in the pool, is formed in an amount not less than 10% of the principal amount of the loans in the pool (a minimum level required in Farmer Mac's statutory charter). The subordinated securities are either allocated between the pooler and originators or sold through a private placement to sophisticated investors, at a yield level substantially higher than the yield on the senior securities. The incrementally higher yield required on the subordinated securities increases the total cost of securitization under this program relative to the experience of the other GSEs. Farmer Mac compensates to some degree by requiring the capital markets to assume the 10% first risk of loss -- well above reasonably anticipated real losses -- through the purchase of the subordinated securities. Thus, for example, if the senior securities were sold to yield 7% and the subordinated securities were sold to yield 18%, the weighted yield on all securities supporting the mortgages would be 8.1%. The added cost of this structure is partly offset by Farmer Mac's lower requirements for compensation (guarantee fees, etc.) relative to the other GSEs, which is possible because it takes less risk than they do.

One or more classes of senior securities are also formed, representing the other 90% of the principal amount of the loans in the pool, and these are eligible for the Farmer Mac guarantee of timely payment of principal and interest. The senior securities are either sold directly to Farmer Mac under the Linked Portfolio Strategy, or to capital markets investors. If Farmer Mac purchases these senior securities under its Linked Portfolio Strategy, it funds the purchase with its own "straight" debt and thereby passes its cost of financing directly through to the pooler. The efficiency of this approach tends to reduce the cost of subordination.

Nevertheless, the cost of the fixed minimum 10% subordination requirement and the number of regulatory obstacles it has generated for the lenders have seriously complicated the implementation of the program. This is not to say that a subordination requirement is a bad idea per se for the agricultural loan secondary market, or for that matter a small business commercial loan secondary market. However, the Act could have further facilitated the development of the agricultural loan secondary market if it had provided Farmer Mac flexibility to set the level of subordination to correspond to the level of risk being assumed in each pool, rather than arbitrarily fixing the requirement at a 10% minimum. (The matching of subordinated security levels to risk

levels is a method commonly used by the monoline bond insurers in the private sector to which Farmer Mac bears a close resemblance, such as Financial Security Associates, Financial Guarantee Insurance Corporation and Municipal Bond Investors Association.)

The Act, and therefore the Securities Guide, permit as an alternative approach the creation of a cash reserve equal to at least 10% of the principal amount of loans in the pool, with its proceeds invested in government securities. This would permit the issuance of guaranteed securities equal to 100% of the principal amount of loans in the pool. As a practical matter, however, the negative spread from the mortgage-backed securities yield down to the yield on the reserve has been a significant disincentive to the use of that alternative.

* *Is insurance (private or governmental) used to reduce risk in the Farmer Mac program?*

Perhaps the most important technique for reducing risk in the Farmer Mac I program is the existence of the subordinated securities or reserve, though neither is denominated as "insurance." Focussing for simplicity on the subordinated securities example, it is the essence of an insurance contract. Credit risk is assumed for a cost moderated somewhat by diversification and statistical predictability, then reallocated to all participants as the higher discount required by the subordinated security investor. Individual loan risk to participants is reduced through reallocation and sharing, converting a random exposure to significant risk to a predictable exposure to nominal risk.

Though criticized by some observers of Farmer Mac, the senior/subordinated securities structure is preferable to both: (a) pro rata 90%/10% (or other combination) risk sharing between Farmer Mac and the originator or pooler; and (b) loan-by-loan 10% first loss assumption by the originator or pooler. The first approach would make Farmer Mac a virtual participant in the loans, requiring that its guarantee fees equal the present value of worst-case future losses. The second approach would be a mitigated version of the first approach, but would still create an incentive for adverse selection of loans to be sold into the secondary market. Here, again, the solution appears to be a grant of flexibility to Farmer Mac to set the subordination level, or at least a substantial reduction from the current 10% minimum.

In the Farmer Mac II program, the USDA guarantee of ultimate payment backed by the full faith and credit of the federal government, though not referred to as insurance, is the critical credit risk reduction technique. The FmHA effectively acts as insurer and collects its premiums partly from the borrower, partly from the lender and partly from the federal appropriations process.

Beyond those two critical forms of protection, akin to insurance, there are many instances of the use of more conventional insurance in the Farmer Mac I program. Title insurance is required for agricultural real estate and rural housing mortgages. Borrowers must maintain hazard insurance on agricultural facilities and on the dwelling in rural housing, with the pooler as a loss payee. In the case of rural housing loans, private mortgage insurance may be used to make 85% loan-to-value ratio mortgages acceptable within a program that is otherwise limited to a 75% ratio (Securities Guide Section 4.48(a)). All originators and poolers in the Farmer Mac I program must have fidelity bonds and errors and omissions insurance in force at all times, naming Farmer Mac as a loss payee (Securities Guide Sections 3.13 and 6.21(e)), though originators and poolers may qualify as self-insurers in certain instances.

- *What information do you require from loan sellers and poolers and is it standardized?*

Farmer Mac does not purchase loans in the Farmer Mac I program, but it does guarantee and purchase securities backed by loans meeting well-defined criteria. Broadly speaking, the information Farmer Mac requires in this program falls into two categories: (a) hard copy and electronic media loan-by-loan data; and (b) representations and warranties as to information in category (a) and other information that may not be included in category (a).

The hard copy -- actual loan files -- must include the loan application, the promissory note endorsed in blank and without recourse, a mortgage or deed of trust, including copies of all assumption, modification and substitution agreements; an unbroken line of assignments of the mortgage from the originator to the pool Trustee; a release of security interest executed by each prior holder of the loan; the a title report or attorney's opinion of title; an appraisal; the borrower's financials (balance sheet and income statement); a credit verification; specification of the location of the property within the USDA's ten U.S. "growing regions"; data on principal commodities produced on the mortgaged property; an environmental survey; and a "qualifying worksheet" which is a brief summary of the key aspects of the loan confirming its eligibility for securitization in a Farmer Mac pool. (Securities Guide, Sections 6.6 and 10.2.) Farmer Mac developed a set of standard loan application forms, recommended but not required for new loan origination, for which it provides at a nominal cost a computer based forms completion and documentation program known as "AGPAK I." While the aforementioned information on the borrower's credit is required for new loans, those details are reduced in the case of "existing loans" five or more years old with no material restructurings, no delinquencies within the last three years and a loan-to-value ratio not higher than 60%. (Securities Guide, Section 4.6.)

The electronic media submission must include the following data for each loan, on a computer diskette or magnetic tape in the format stipulated by Farmer Mac: borrower name; address including zip code; loan amount; interest rate; maturity date; balloon amount, if any; schedule of cash flows; appraised value of property; loan-to-value ratio; principal commodities produced; name of originator; and various other financial information necessary to calculate credit ratios (Securities Guide, Appendix M). Farmer Mac will provide poolers at no charge a computer software program that transfers the relevant data directly to the required data base from AGPAK I loan application files.

In addition to the foregoing, certain information is required to be represented and warranted by the pooler and the originator to Farmer Mac, including: the good standing and legal authority of the pooler to enter into the transaction; the qualification of the mortgage loan for securitization under the terms of the Farmer Mac I program, as set forth in the Securities Guide; the pooler's and originator's clear title to the mortgage and note and ability to transfer them to the securities Trustee; the existence of a valid title insurance policy or attorney's opinion (in states where title insurance is unavailable); the first lien status of the mortgage; the good condition of the mortgaged property; the completeness of the each loan file (as to the contents specified in the preceding paragraph of this testimony); the loan is representative of the quality of other similar loans made by the originator; the validity and legal enforceability of the note and mortgage; there have been no defaults on the loan; all federal, state and local legal requirements in connection with the making of the loan were complied with; all improvements on the mortgaged property are covered by hazard insurance naming the pooler as loss payee; the proceeds of the loan have been fully disbursed; each loan was made by the pooler or an originator; the pooler has complied with the provisions of the Securities Guide; and the pooler has obtained from the originator (if other than itself) representations and warranties substantially the same as those it is providing to Farmer Mac. The full text of these representations and warranties, which are negotiable to a degree between Farmer Mac and the pooler on a pool-by-pool basis, is set forth in the Securities Guide, Section 11.4.

In the Farmer Mac II program, Farmer Mac does directly purchase guaranteed portions of FmHA guaranteed loans. In those cases, we require: (a) an executed standard Sale Agreement; (b) a schedule of Guaranteed Portions; (c) a Loan Note Guarantee (FmHA Form 449-34); (d) an Assignment Guarantee Agreement (FmHA Form 449-36); (e) an executed Loan Note; (f) a Loan Note amortization schedule; and in certain cases (g) a securities delivery schedule. The details of this information are set forth in Section 2.4 of the Farmer Mac II Loan Purchase Plan.

To a large degree, as indicated in the prior paragraphs, the information required by Farmer Mac is standardized. Notable exceptions are the forms of the loan application, note and mortgage (or deed of trust), but the accuracy and legal

enforceability of these documents is addressed in the representations and warranties. Thus, the lack of standardization of agricultural mortgage loan information has been largely overcome. Fannie Mae and Freddie Mac standard documentation is accepted for rural housing loans. While Farmer Mac has developed model agricultural mortgage loan clauses, it has not attempted to set and require one standard form for agricultural loan documents at this stage of program development. As Farmer Mac determined in the course of developing its diversification standards, there are at least sixteen distinct commodity groups in U.S. agriculture. The special characteristics of documentation relevant to loans for producers of those sixteen commodity groups, combined with what are often idiosyncratic laws of the fifty states relating to agricultural real and personal property and liens thereon, make total standardization impractical at this stage. Accordingly, the model clause approach seemed more appropriate for the start-up of this market. Farmer Mac anticipates that greater standardization will occur in the agricultural credit industry over time, as the secondary market becomes more established and the benefits of securitization provide sufficient incentives for lenders to accept standardization.

- *What exemptions from existing law does Farmer Mac benefit from?*

Loans made for sale into the Farmer Mac secondary market are exempt from state usury laws, unless a state takes express legislative action to the contrary. Certain borrowers' rights applicable to loans made by Farm Credit institutions prior to the effective date of the Act are inapplicable if those loans are sold into the Farmer Mac secondary market. Farmer Mac is exempt from payment of state taxes. Farmer Mac securities, i.e., corporate stock and debt obligations, are exempt from registration under the Securities Act of 1933, though Farmer Mac guaranteed mortgage-backed securities are expressly required to be registered under the 1933 Act. Farmer Mac securities are also exempt from most state securities laws. Farmer Mac is, however, a reporting company under the Securities Exchange Act of 1934, necessitating the filing of periodic reports on Forms 8K, 10K, and 10Q, as well as its Annual Report to Stockholders and Proxy Soliciting Materials and Forms 4 and 5 reporting transactions in Farmer Mac stock by directors and officers.

- *What is the level of institutional buying (pension funds, insurance companies) of your products?*

The predominant purchasers of Farmer Mac debt securities and guaranteed senior securities to date have been institutional investors. While the market for the subordinated securities has not been developed as extensively (several poolers have retained the subordinated securities in light of their information advantage over the

market), the general profile of the investors in those securities is recognized as institutional investors and certain bond funds.

* *What are the lessons to be learned from the Farmer Mac experience?*

There are several lessons to be learned from the Farmer Mac experience. First, and most important to the members of this Committee, our experience demonstrates with certainty that commercial loans can be effectively and efficiently securitized. Notwithstanding the lack of statistical data on agricultural loan performance or the lack of common loan characteristics (as has been repeatedly pointed out by GAO during the development of Farmer Mac), we have successfully created a secondary market mechanism that performs on a level comparable to the residential housing secondary market agencies. Clearly, Farmer Mac encountered numerous challenges and set-backs because of the unique nature of the loans it was working with and the structure provided in its charter, but we found effective means to overcome those challenges and to make the process work for this sector of the credit industry.

More specifically, it is also clear from the Farmer Mac experience that the required use of subordinated interests to mitigate the guarantee risk exposure taken by the secondary market GSE is a workable structure. We would emphasize at this point, however, that the mandatory 10% minimum subordinated requirement imposed on Farmer Mac has been a significant obstacle to the implementation of the secondary market. If this structure is to be used, it would be preferable for the legislators to provide the GSE with sufficient flexibility in its application that the subordinated level can be effectively tailored to the risks presented with each pool of loans.

On this point, we would go on to observe that flexibility is also critical in the structuring of a secondary market statute generally. We have seen dramatic changes take place in the economics of agricultural lending and borrowing in the few short years since Farmer Mac's charter was enacted (1988), which have affected the development of the secondary market. Unfortunately, the Farmer Mac charter was too rigid and inflexible in some respects to allow Farmer Mac to quickly and efficiently adapt to the changes. The end result has been for the implementation of the Farmer Mac secondary market to lag behind the expectations of many interested participants in the industries to be served, which has unfortunately obscured the enormous potential value that Farmer Mac offers to agricultural lenders and borrowers. Through diligence and determination we have overcome much of the inflexibility we faced but not without considerable cost in time and lost opportunity.

* *What are the benefits, and disadvantages, of using a GSE to stimulate development of a secondary market?*

With proper structuring to effectively insulate the government from liability for the operations of the GSE, we believe that the use of a GSE structure has the benefit of providing a new secondary market with instant credibility in the eyes of the capital markets investors and other potential participants. This provides an effective means therefore to stimulate the securitization of loans in a marketplace where the players have otherwise shunned this activity.

We are well aware of the debate, regarding the merits of using GSE type organizations for secondary market purposes and the contingent liability of the government that arises as a result of the activity of the GSE's. However, there is clearly a balance between providing the benefits of achieving the Congressional public policy goal of a stable supply of competitively priced credit to different sectors of our economy at no budgetary cost to the government and minimizing the disadvantage of contingent liability to the government. The use of a subordinated structure, similar to that in the Farmer Mac program, to impose the first risk of loss from the GSE activity on the private investment sector could very well provide Congress with the measure of comfort needed to address the concerns about risk exposure to the government. The alternatives to the use of a GSE, as we see them, are for Congress to commit the government directly, where the need justifies the budgetary expenditure, or to defer to the private sector without government sponsorship, recognizing that desirable public policy objectives may not be realized in this event.

Recognizing the public policy objectives facing the members of this Committee -- to find an effective but low cost means of relieving the credit crunch confronting the small business borrowers of our nation -- the use of a GSE structure is in our opinion the most efficient and timely approach available.

Conclusion

In Farmer Mac I, there are currently nine certified poolers. Four loan pools aggregating over 2300 agricultural real estate loans with a cumulative principal value of almost $700 million have been securitized. The early offerings of Farmer Mac guaranteed mortgage-backed securities and debt securities were enthusiastically received by capital markets investors and priced at levels comparable to similar securities issued by the other secondary market agencies. Based on those successes, two of Farmer Mac's poolers are now running "open window" pooling operations that make the Farmer Mac secondary market widely available to all eligible agricultural lenders for the first time. Loan pricing under those programs is resulting in some of the most competitive rates in

the marketplace. Based on the rates now available from poolers to originators, lenders now have the opportunity to offer their borrowers access to a stable source of competitively priced funding for agricultural real estate and rural housing mortgages.

In Farmer Mac II, the secondary market for Farmers Home Administration (FmHA) guaranteed loans, which was authorized by Congress in the 1990 Farm Bill, approximately $46 million worth of FmHA guaranteed loans have been securitized to date and the monthly volume of new transactions is growing steadily. In May 1991, Farmer Mac announced a major breakthrough in its pricing structure for certain variable rate guaranteed loans under the Farmer Mac II program. For lenders who base variable rate loans on the Farmer Mac Cost of Funds Index (COFI), the "Net Yield" required to be paid by the lender for loans sold into Farmer Mac II is very competitive.

Consistently during the development of Farmer Mac -- the newest government sponsored secondary market -- we have faced the challenges of securitizing commercial agricultural real estate loans and succeeded in achieving funding efficiencies for agricultural borrowers nearly comparable to those provided to borrowers through the other secondary markets. This was accomplished under a statutory charter imposing numerous constraints not previously placed upon any other secondary market agency and without any contribution by or cost to the federal government. During the last few years, Farmer Mac has developed an efficient secondary market opportunity for agricultural lenders and borrowers in the face of regulatory and business conditions not previously encountered by any other GSE. While we would like to volume of guaranteed securities to be greater, and we are confident it will be in the future, the Congressional objectives for the program are now being met.

By reviewing in this testimony the experiences of our development and the elements of Farmer Mac's structure that have been both positive and negative to its development, we hope to have provided this Committee with information that will be particularly helpful to its consideration of the matter of creating a secondary market for small business loans. We appreciate having this opportunity to participate in this hearing process and would be pleased to respond to any questions members of the Committee may have about Farmer Mac. Thank you.

Appendix I

Historical Details

Farmer Mac was created in January 1988, when the Agricultural Credit Act of 1987 was signed into law. Five months later, an interim Board of Directors was appointed, to capitalize the corporation and organize the election of a permanent Board of Directors. The stock was sold in November of 1988, approximately 55% to banks, insurance companies and investment banks and 45% to Farm Credit System institutions. The permanent Board of Directors was first seated in March of 1989 and corporate management and other staff were substantially in place by the end of that year. As was noted earlier, the Securities Guide was issued in January 1990, and Farmer Mac has been open for business since that date.

"Getting the market off the ground" during the intervening time has involved the completion of technical work on the design of this secondary market and demonstrating its efficiency in transferring funds from the capital markets into the agricultural credit sector. The challenges of accomplishing this within the market dynamics outlined above were considerable.

During 1990, Farmer Mac's first full year in operation, the Board and management focussed their attention on the process of educating originators and potential poolers about the operating details and business opportunities of the Farmer Mac program. Presentations were made to all of our major stockholder organizations, and meetings were held with many other interested financial, commodity and trade groups. AGPAK I, our computer software package that simplifies the completion of application forms, was made available to lenders at a nominal charge. Model note and mortgage forms -- a first for agricultural lending -- were drafted for use in the Farmer Mac program.

It was also during 1990, however, that the first major federal regulatory issues -- matters not addressed in the statute that created Farmer Mac -- arose as obstacles to lender access to the program. Initially, the issues were capital and lending limits requirements on potential participants in the secondary market. Lenders who sold loans into Farmer Mac pools and retained any of the statutory subordinated interest in the pools were being told by their regulators that capital requirements and lending limits would be applied as though the loans had not been sold. These regulatory positions had a chilling effect on the willingness of lenders to become involved in the program.

Accordingly, a considerable effort to eliminate these constraints was made by Farmer Mac and lender organizations.

By the end of June 1990, the regulators had adopted a constructive position on the lending limits issue but not on the matter of capital. Other ongoing regulatory constraints, unique to Farmer Mac, have also continued to complicate implementation of our programs, but have been repeatedly overcome. Farmer Mac guaranteed securities have been denied access to the Federal Reserve Book Entry Wire system, for the ironic reason that they are required to be registered under the Securities Laws and so investors will have less confidence in purchasing them. An acceptable alternative proved to be book entry trading provided by the private sector through Depository Trust Corporation ("DTC"). Other examples can be provided.

The resolution of the lending limits issue cleared the way for the certification of the first Farmer Mac pooler, Manufacturers Hanover Securities Corporation, in September. Subsequently, in January 1991, Goldman Sachs Mortgage Company was certified as our second pooler. No transactions were consummated by either firm in 1991, however. During the first half of the year, this was attributable to high interest rates and declining farm debt. During the second half of the year, it was due to the previously mentioned disincentives which lessened during the year but were joined by uncertainty over Farmer Mac's authority to implement the Linked Portfolio Strategy (LPS) it introduced in June 1991.

Communication between Farmer Mac and its potential participants was a critical element in the development of the programs and led to the formulation of the LPS. During the first months of 1991, we focussed considerable effort on rapid implementation of Farmer Mac II. In April, we issued the first Farmer Mac II guaranteed securities. As the volume of guaranteed portions sold and the number of Farmer Mac II participants increased, Farmer Mac established and implemented a Discount Note Program during March and April. Its immediate success led us to designate the "Farmer Mac Net Yield" (a rate based on the our cost of funds in the capital markets and plus our guarantee fee) as an acceptable index for adjustable rate loans purchased by under Farmer Mac II.

The wide difference between the Farmer Mac Net Yield and prevailing FmHA loan rates offered lenders the opportunity to reduce their interest rates to FmHA-guaranteed borrowers while dramatically improving the profitability of those loans. A significant aspect of the Farmer Mac II program was the opportunity it created for agricultural lenders to expand their lending activities with starting farmers and expanding young farmers by enhancing the lender economics of loans to these important but less established new prospects.

The attractive economics of the new Farmer Mac II pricing structure became known throughout the agricultural lending industry during the spring of 1991. Farmer Mac received requests from agricultural lenders to extend that structure to Farmer Mac I and responded in June, with the introduction of the LPS at the Annual Meeting of Stockholders. By mid-summer, interest in Farmer Mac I had picked up to levels not seen since the initial public offering of Farmer Mac common stock in 1988. This occurred despite reduced agricultural real estate loan volume and increased lender liquidity. Several insurance industry and Farm Credit System lenders began to apply for certification as Farmer Mac poolers. Our existing poolers identified several potential pools and submitted loan data to us for analysis.

At the end of August, however, the Farm Credit Administration (FCA) issued a legal opinion challenging Farmer Mac's authority to proceed with the implementation of the LPS. The FCA's interpretation was contrary to the legal opinions of several major law firms and the American Law Division of the Congressional Research Service we had previously received supporting Farmer Mac's authority. Although the FCA did not initiate any formal regulatory action on the issue, the release of its legal opinion thwarted pending business opportunities. This led Farmer Mac to seek Congressional clarification of its authority to proceed with LPS. At the same time, the FCA sought to broaden its regulatory authority over Farmer Mac.

When Congress passed the critical legislation confirming Farmer Mac's authority to proceed with the LPS in late November, the law also granted the FCA general rulemaking authority over Farmer Mac and established minimum capital requirements for Farmer Mac. With its expanded authority over Farmer Mac, the FCA revised its assessment of regulatory fees from approximately $75,000 to an annualized rate of nearly $650,000. FCA's budget for its regulation of Farmer Mac was later capped by Congressional appropriators at $300,000 for FY 1993.

Uncertainty over FCA regulation and the availability of LPS discouraged several poolers (some indefinitely) and delayed several previously active pooling opportunities well beyond the end of the year. The market bid for Class A units fell from the $16.75 level that had prevailed from January to August to $9.50 by early October, well below the $14.00 book value of the units. Thus, while Farmer Mac's authority to proceed with LPS was clarified, the costs were significant.

Still, the advantages of the legislation appear to have outweighed the drawbacks. Continued progress toward the implementation of Farmer Mac I throughout the fall of 1991 was greatly facilitated by the pendency of this legislation and the early support of LPS expressed by many members of Congress. Building on interest they developed prior to the end of August, and anticipating favorable Congressional action on LPS, three major institutions -- Prudential Agricultural Credit, Inc., John Hancock Mutual Life Insurance Company and Equitable Agri-Business, Inc. -- became Farmer Mac poolers in

September, October and November, respectively. At the same time, we continued to work with all of our poolers on the formation and analysis of potential loan pools without the benefit of the LPS structure. Those efforts came to fruition in early December, when the first Farmer Mac I guaranteed securities were issued in a non-LPS transaction backed by a pool of $112 million in agricultural loans from John Hancock.

Farmer Mac entered 1992 with five certified poolers, its first major pooling transaction completed and legal authority for LPS clarified with strong Congressional support. Against that backdrop, we proceeded with an intensive effort to educate our poolers on the details of the LPS approach to securitizing loans and on the favorable economics available through this mechanism. In addition, other steps to facilitate program implementation were taken. Farmer Mac Mortgage Securities Corporation, a wholly owned subsidiary of Farmer Mac, was chartered in the State of Delaware to carry out the critical functions under LPS of purchasing the guaranteed mortgage-backed securities. A medium-term note program to fund the purchase of the securities was developed and prepared for introduction. In addition, extensive work was done to develop pooling documents, analyze possible security structures and evaluate loan portfolios for compliance with program standards.

By early spring, two of Farmer Mac's poolers had each identified and screened approximately $250 million worth of loans for securitization and were working on the details of forming pools. In late May, the first of these pools went to market and was quickly followed by the second pool in early June. The poolers involved -- Chemical Securities, Inc. (successor to Manufacturers Hanover) and Prudential Agricultural Credit, Inc. (in conjunction with Goldman Sachs & Co., Inc.) -- both used our "Linked Portfolio Strategy" as the pricing structure for the pools and successfully demonstrated the attractive economics available under this approach. These two transactions facilitated the securitization of 1393 agricultural loans with a total principal value of about $471 million. At the same time, Farmer Mac issued approximately the same dollar amount of medium-term and discount notes to capital markets investors and used the proceeds to purchase the guaranteed securities issued against the agricultural loan pools under the LPS structure. The loans in the pools were widely diversified, extending into all ten of Farmer Mac's specified geographic regions and representing a broad spectrum of commodities produced across the United States.

These transactions represented a significant step forward in the implementation of our programs. Further, they represented the first major injection of income to fund Farmer Mac's operations from the guarantee fees associated with the pools. In addition, despite its status as the newest "agency" issuer of medium-term notes, Farmer Mac achieved interest rates only slightly higher than the rates on Treasury securities of comparable maturity. The benefits of these competitive funding rates were then passed back to the poolers and originators of the pooled loans through the pricing of the

loan-backed securities. The success of these transactions and the strong interest shown in the program by investors and poolers provided an important boost to our continuing marketing efforts.

By mid-summer, work was progressing on a potential fourth pool, being formed by Equitable Agri-Business, a certified Farmer Mac pooler. By October 1992, intensive work with Equitable had resulted in the first public sale of SEC registered mortgage-backed securities guaranteed by Farmer Mac. The pool, which consisting of 374 loans secured by agricultural real estate in 28 states and representing commodities in 11 of our 16 commodity categories, was an important step in the secondary market. The guaranteed securities issued by Equitable, worth $87,908,000, produced breakthrough economics for the Farmer Mac I program. The Farmer Mac guaranteed mortgage-backed securities were priced head-to-head with comparable securities issued by Fannie Mae. With the completion of this fourth pool, over 2,300 agricultural loans with a total principal balance in excess of $700 million had been securitized in the Farmer Mac I and II programs combined.

Shortly after the closing of the Equitable mortgage-backed securities sale, several additional agricultural lenders began to seek pooler certification. The submission of applications by two of these institutions led to the certification of the Travelers Realty Investment Company and the Farm Credit Bank of Columbia as poolers near the end of December.

By the close of 1992, Farmer Mac had certified eight poolers and guaranteed senior securities with a combined principal value of about $615 million in connection with the completion of four pools under the Farmer Mac I program.

Activity also increased in the Farmer Mac II program throughout 1992 with the issuance of approximately $22 million worth of securities backed by Farmers Home Administration guaranteed portions during the year. Contributing to the increased business volume in this program was Farmer Mac's mid-summer announcement of new pricing opportunities on 20-year fully amortizing loans with intermediate-term interest rates resetting after 5-year and 10-year periods. Farmer Mac II business volume was approximately $32 million at the end of 1992, with monthly volume of new business running at about $2 to $3 million and growing slightly.

The experience gained in the capital markets with the three 1992 pools clearly demonstrated that the Farmer Mac secondary market was sound and supported competitive funding rates for agricultural loans. It was also clear that Farmer Mac offered a particularly attractive funding mechanism for intermediate- and long-term interest rate products, in addition to the short-term and floating rate products that had dominated the agricultural credit industry for many years. Farmer Mac's securities were

readily accepted by capital markets investors and the favorable economic results achieved in the sale of the guaranteed securities was on par with the economics of the other more established secondary market agencies serving residential housing markets.

Based on our pooling experiences to date, it is certainly possible for agricultural lenders to profitably make loans with intermediate-term interest rates, such as 5-, 7-, 10- and 15-year reset periods, and possibly longer. Agricultural mortgage loans can be made at rates nearly comparable to those being offered to residential mortgage borrowers, despite the commercial nature of the agricultural loans. This experience coincides with the current period of low interest rates and offers an opportunity for farm borrowers to benefit by locking in the cost of their real estate credit for the long-term rather than continuing to speculate on short-term interest rates as they have for many years.

As Farmer Mac entered 1993, the momentum from 1992 continue to build. In April we finalized our review of an additional pooler application and certified Farmer Mac's ninth pooler -- the Western Farm Credit Bank. At the same time, we had one partial pooler application on file and had received inquiries from other institutions regarding their interest in possibly seeking certification as well. Further, among our existing poolers, several participants were actively working on the initiation of an "open" pool, designed to focus on new qualified loans originated by any eligible originator. This opportunity was facilitated by the introduction in late 1992 of Farmer Mac's "High Gear" initiative to: streamline pooling procedures; provide for the pre-approval of qualified loans; provide interim funding during pool accumulation; and assist in the networking of originators and poolers.

In early February, the details of one new pooling program were firmed up and the first announcement was made by the pooler, Prudential Securities Inc. It offers lenders, regardless of their affiliation, an "open window" through which to sell loans yielding below 8.5% on a 15 year fixed rate loan product. This pricing will meet or beat the most competitive rates on loans previously available to most agricultural borrowers from any sector of the credit industry. At this time, a network of loan aggregators is being identified for participation in the pooling program and initial loans are being screened for purchase by the pooler. Also underway at this time is a second open pool being offered by the Travelers. Using its own field office network to aggregate loans into the pool, Travelers is offering to buy qualified long-term loans with interest rate reset periods of 5, 10 and 15 years. Depending on the duration of the interest rate reset period, this program offers borrowers access to rates ranging from about 7.5% to slightly over 8.5%.

The favorable rates available through both of these pools is made possible through the use of our LPS structure, so it is not anticipated that the sale of mortgage-backed securities into the capital markets will result from these pools. Even

though the equitable pool established the acceptance of Farmer Mac guaranteed MBS in the capital markets, the spread demanded by investors together with the added costs of carrying the subordinated securities under our statutory structure result in loan rates unacceptably high to most agricultural borrowers. The commercial nature of the loans along with investor uncertainty about prepayment characteristics and general concern about the riskiness of these types of loans necessitates the use of the LPS structure to achieve a competitive rate for the borrowers.

Appendix II

Farm Lending Environment, 1990-93

Business conditions in 1990. In addition to the regulatory issues Farmer Mac faced in 1990, adverse economics also impeded pooling activities. High interest rates and declining farm debt were the primary adverse economic factors in 1990. Following the initial capitalization of Farmer Mac in late 1988, long-term farm real estate interest rates rose and remained at levels that discouraged long-term fixed rate borrowing during 1989 and much of 1990. Short-term rates were low, and there were predictions of declines in long-term rates which finally materialized in late 1990. This predisposed borrowers toward short-term variable rate financing.

Although agricultural interest rates declined late in 1990, the higher rates of the preceding several quarters tainted the environment for initiation of the secondary market and contributed to frustrating delays in program implementation.

Another significant factor was the general contraction of agricultural debt that began in the mid 1980's and continued into 1990. There was a dramatic 31% decline in total farm debt from the 1983 peak of $192.7 billion to $133.9 billion in 1990, the lowest level since 1978. This dampened loan demand and resulted in excess liquidity and lending capacity for many agricultural lenders. Average loan-to-deposit levels at agricultural banks declined during 1989 and the first half of 1990 to an undesirably low 55.3%. Loan activity had improved slightly by year end 1990, but no significant change in demand for funds occurred.

Business Conditions During 1991. Business conditions in 1991 were impacted by several critical factors. Loan demand was important, but by no means determinative of secondary market volume. The supply of existing high quality loans held in portfolio by agricultural lenders turned out to be more important in the short-run. The efficiency of the secondary market was also critical, but 1991 demonstrated that the inclination of agricultural lenders to sell loans was the most elusive factor in the success of this secondary market.

For the year, farm real estate mortgage volume was up slightly (1.7%) from 1990, but down considerably (9.5%) from 1987, the year Congress passed the legislation creating Farmer Mac and even more (30.1%) from the peak level of the mid-1980's.

Also, as lenders emphasized higher quality standards for agricultural borrowers, in response to regulatory pressure, competition among lenders for the limited volume of high quality loans intensified.

Falling interest rates throughout the year further limited lenders' inclination to sell agricultural loans. During the year, the Federal Reserve eased its rates to member banks from 6.5% to 3.5%, while the Wall Street Journal Prime Rate declined from 10.0% to 6.5%. Investors waiting for more attractive rates in other longer term, non-bank securities invested in short-term instruments such as bank certificates of deposit (CDs), creating high liquidity levels at many commercial banks. Although loan-to-deposit ratios at agricultural banks increased slightly during 1991, they remained in the range of 56 to 57 percent, well below desirable levels and far less than historical averages. The situation among community banks in the midwest, many of which are Farmer Mac stockholders, was even worse, with many of these banks showing loan-to-deposit ratios below the national average. These conditions of high liquidity coupled with low alternative investment opportunities prompted lenders to hold loans rather than sell them.

Falling interest rates in 1991 permitted another of Farmer Mac's principal stockholder groups, the Farm Credit System institutions, to benefit from reductions in their cost of funding through the Farm Credit Funding Corporation. Focusing on variable rate loans with short-term resets, facilitated by the low funding rates, the Farm Credit System lenders were able to meet borrower needs effectively without taking on interest rate risks from holding the loans in portfolio. These factors provided no economic incentives for Farm Credit System lenders to securitize loans. Thus, their interest in using Farmer Mac during 1991 remained low.

While insurance company agricultural lending operations continued to have good access to parent funding in 1991, their interest in Farmer Mac increased as they sought to establish the liquidity of agricultural loans through securitization and sale in the secondary market. This created the brightest spot in the our business during 1991, with even more favorable prospects for 1992. Many of the insurance company agricultural lenders interested in Farmer Mac programs were hesitant to originate new loans conforming to Farmer Mac standards without the certainty of economically attractive sale into a secondary market. Accordingly, their immediate interest in securitization focused on existing loans, where the economics of the secondary market could be tested without the cost and effort of establishing a customized loan origination system. Farmer Mac responded by clarifying the terms upon which existing loans could be securitized in the programs which contributed significantly to the formation of loan pools later in 1992.

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Business Conditions During 1992. Business conditions during 1992 were similar to conditions of the previous year.

Farm real estate mortgage volume was up slightly (about 1%) from 1991, but lenders continued to emphasize higher quality standards for agricultural borrowers, due to regulatory pressure. Short-term interest rates continued to fall while long-term rates lagged behind during most of the year further contributing to the inclination of agricultural borrowers and lenders to stay with variable rate financing. In addition, with continuing wide spreads between short- and long-term rates, most borrowers seeking long-term fixed rate loan products faced non-competitive high rates relative to those available on short-term products. This situation began to change late in the year as long-term rates move downward, facilitating the attractive loan products being offered in the two open pools now available to agricultural borrowers.

During the year, the Federal Reserve eased its rates to member banks somewhat, from 3.5% to 3.0%, and the Wall Street Journal Prime Rate continued its decline from 6.5% to 6.0%. Loan-to-deposit ratios at agricultural banks increased from previous years, but remained below desirable levels, which continued to discourage banks from selling agricultural loans.

As was true in 1991, the Farm Credit System institutions continued to take advantage of the reductions in their cost of funding through the Farm Credit Funding Corporation. These savings were reflected in lower short-term rate loans to their agricultural borrowers and wider profit spreads to these lenders. As a whole, 1992 was a banner year for the System which posted its highest net income -- over $800 million -- in many years.

Most insurance company agricultural lending operations continued to have adequate parent funding in 1992, although several firms began to noticeably reduce activity in this area by the end of the year. Interest in Farmer Mac at most of the involved insurance companies focussed on the securitization of existing loans then being held in portfolio. This provided the fuel for two of the three loan pools securitized during the year with the third including loans originated during the last two or three years specifically for securitization and sale in the secondary market.

STATEMENT

OF

MICHAEL A. JUNGMAN
VICE PRESIDENT
CAPITAL MARKETS

BEFORE THE

COMMITTEE ON SMALL BUSINESS
OF THE
U.S. HOUSE OF REPRESENTATIVES

10:00 A.M,
MAY 6, 1993
ROOM 2359-A
RAYBURN HOUSE OFFICE BUILDING

Good morning Mr. Chairman and Members of the Committee. My name is Michael Jungman, and I am Vice President of Capital Markets of the Resolution Trust Corporation (RTC). I am pleased to be here to discuss the feasibility of a secondary market for commercial business loans.

The RTC launched its asset securitization effort in June 1991, with an offering of single family mortgage-backed securities, known as MBS. Since this initial offering, the RTC has securitized a wide range of asset types, including multifamily mortgages, commercial mortgages, second mortgages and mobile home loans. With over $36 billion in securities sold since the program's inception, the RTC is considered in many quarters as not only a large issuer of securities, but also an innovative one as well.

The reasons for the RTC entering the securities markets are very straightforward: namely, price, execution and liquidity. Additionally, the basic value of any securitization process is to widen the pool of potential capital attracted to such assets, including investors who would not otherwise be interested in such assets. These are some of the same factors that have led many people to explore the relevance of securitization to the expansion of credit for small businesses. I would like to share with the committee what we have learned about securitizing hard-to-sell assets in the hope that it will prove useful to the

committee as it evaluates various options. Let me state clearly that although the RTC has sold and collected $5.8 billion of non-mortgage commercial business loans, we have not yet securitized this particular asset category.

First of all, it would be incorrect for me to say to you that the RTC developed its program by itself. The RTC has been successful because it worked hand-in-hand with the private sector. The role of the RTC has been to use financial technology developed by Wall Street. In hindsight, our decision to build on credit enhancement devices and bond structures that were developed for use by private sector issuers was the correct one. For example, the RTC's first single family issues were very similar to issues that were done by thrifts and mortgage companies in the private sector. In other words, we tapped into an already well defined secondary market. The reps and warranties, the ratings, and the bond structures were all familiar to investors. Not only did this facilitate the marketing of the bonds, it also saved money for the taxpayer, as the RTC was able to come to market faster than it would have if the program had been attempted from scratch.

Secondly, the RTC has benefited from a relatively well-developed tax and legal infrastructure. The availability of SEC shelf registration for residential MBS, and more recently, commercial mortgages, has provided investors with full disclosure while

minimizing the time and legal expense needed to publicly market securities. The existence of acts passed by this body, such as the Secondary Mortgage Market Enhancement Act of 1984, has simplified the process of offering securities in many states. The creation of a special body of tax laws for mortgage-backed securities, the Real Estate Mortgage Investment Conduit Act of 1986, has been especially important. The REMIC rules have helped eliminate many of the tax problems associated with pooling individual mortgages into securities while providing clarity to investors as to the tax treatment of the resulting instruments. This corpus of securities and tax laws is not now available for all types of business loans, which may complicate the structuring, marketing and purchase of these securities.

Third, the RTC has benefited from regulatory capital treatment for many of its securities. For regulated depository institutions, it is advantageous to invest in residential mortgage securities, as the institution has to hold less capital to support such investments. As this makes the securities more attractive, issuers can pay lower yields on these securities than securities of comparable rating and duration, such as commercial MBS, that lack more favorable capital treatment.

None of these factors were developed solely for the RTC; we simply adapted what was available to fit our needs. Most importantly, we did it in a fashion that did not rely upon government guarantees. The use of government credit guarantees would have undoubtedly led to faster execution at higher prices, but would not have helped the private sector markets as much. The RTC has shown what can be done, and one need merely read the financial pages to see that the private sector is following. For example, there is now an active market for non-performing commercial mortgages that many banks, thrifts and insurance companies are using to liquidate their non-performing loans and REO.

The RTC's experience in securitization is more similar to that of private sector issuers of mortgage- and asset-backed securities than it is to the experience of Fannie Mae, Freddie Mac and other GSE's. As noted above, the RTC has relied on reps and warranties, ratings, bond structures and credit enhancements that are typically utilized by private sector issuers. The GSE's, in contrast, enjoy the perception of an implied government guarantee that makes many of those factors less important. Accordingly, RTC MBS price and trade at levels comparable to private label issuers. In addition, the GSE's are able to control the quality of their collateral by imposing stringent loan eligibility criteria. The RTC, in contrast, has no control over the quality of the loans in its inventory, and must compensate for the poorer

quality of the asset pool with higher levels of credit enhancement and other structural features.

The challenge of securitizing commercial business loans is, in a technical sense, even greater than the one faced by the RTC in securitizing its mortgages. In large part, this is due to the nature of the asset. For some types of business loans, the appropriate credit analysis is much more complicated than it is for others, and credit rating agency criteria are much less developed. The servicing is complicated, because most commercial loans take the form of a line of credit. This means that principal balances can change radically from month to month as the borrower either makes payments to or advances against their line of credit. The complexity of the asset is compounded by the lack of a clear legal and tax infrastructure available to support its securitization.

In conclusion, the RTC's experience shows that it is possible for a government entity to expand the secondary market without the use of government guarantees largely by coordinating with the private sector in developing the necessary framework.

OPENING STATEMENT FOR
JOHN J. LaFALCE, CHAIRMAN

ROUNDTABLE ON CREDIT CRUNCH

MAY 12, 1993

Today's roundtable is part of a continuing inquiry this Committee has been conducting into the credit crunch affecting small business.

On March 10, when President Clinton announced his proposal to revise banking regulations to increase small business lending, a significant chunk was taken out of the credit crunch wall. But much of the wall remains.

Without access to credit, small businesses die off or stagnate. When they do, good businessmen suffer unjustified reversals, jobs disappear, and our economy as a whole suffers.

Forty years ago Congress determined that part of the solution could be provided through financing under a program to be operated by the Small Business Administration. Initially, this program consisted of direct or government-made loans, but over the years it evolved into a program under which SBA guarantees loans made by private lending institutions.

The credit demand today, however, is so enormous that the program has already used its entire allocation for the year and has closed until the first of October when we commence a new fiscal year. This, of course, is intolerable and we are working to ensure that SBA's 7(a) program is included in the supplemental appropriation bill which hopefully will be passed and signed into law very soon.

But it is also time to take Federal financing to a new plateau. I think we should take advantage of a system which has been utilized effectively in other sectors of our economy, such as the housing sector, for decades -- the development of a government sponsored enterprise but, this time, focused on small business financing. I have proposed the establishment of such an entity, which I call "Velda Sue." Velda Sue would link small businesses to the long-term funds of institutional investors.

I believe Velda Sue would help solve some of the problems we will be hearing about today. This is Small Business Week and small business owners and operators are convening here in Washington to celebrate this event. A number of them have agreed be with us this morning and to relate their personal experiences. I am extremely pleased that they have done so. Our purpose in today's discussion is to secure first hand information on the financing needs of small firms and the results of their failure to obtain this financing.

Before we begin, I would also note that we now have a new Administrator of the Small Business Administration, Erskine Bowles. I met with him prior to his confirmation and was pleased to learn that he understands the importance of increasing the availability of finance to the small business sector. I look forward to working with him in the months to come and would further note that he will appear before the Committee next Wednesday.

Do other Members have opening remarks?

THE HONORABLE KWEISI MFUME

OPENING STATEMENT

BEFORE THE COMMITTEE ON SMALL BUSINESS

MAY 12, 1993

ROUNDTABLE ON CREDIT AVAILABILITY

GOOD MORNING MR. CHAIRMAN, MEMBERS OF THE COMMITTEE, AND OUR ROUNDTABLE PANELISTS. WE ARE HERE TODAY TO DISCUSS THE IMPORTANT PROBLEM OF ACCESS TO CAPITAL FOR SMALL BUSINESSES. THIS IS A COMPLICATED PROBLEM, ONE THAT DESERVES OUR FULL ATTENTION. I WOULD LIKE TO THANK THE PANELISTS ASSEMBLED HERE FOR APPEARING AND FOR SHARING THEIR EXPERTISE WITH THE COMMITTEE.

AS CHAIRMAN OF THE SUBCOMMITTEE ON MINORITY ENTERPRISE, FINANCE, AND URBAN DEVELOPMENT I AM ESPECIALLY CONCERNED WITH THE PLIGHT OF SMALL, MINORITY BUSINESSES IN THIS COUNTRY. HISTORICALLY, THESE BUSINESSES HAVE FACED HEIGHTENED DIFFICULTY IN OBTAINING ACCESS TO CAPITAL FOR THEIR BUSINESSES. IT IS IN THIS LIGHT THAT I ANALYZE PROPOSED SOLUTIONS TO THE CREDIT CRUNCH. IT IS MY HOPE THAT WHATEVER SOLUTIONS ARE PROPOSED WILL SPECIFICALLY ADDRESS THE PROBLEMS OF THE MINORITY BUSINESS COMMUNITY.

AS WE ALL WILL AGREE, SMALL BUSINESS DRIVES OUR ECONOMY. AND INCREASINGLY, MINORITY AND WOMEN OWNED BUSINESSES ARE A LARGER PROPORTION OF THE SMALL BUSINESS COMMUNITY. FOR THIS REASON, WE SHOULD NOT VIEW PROGRAMS GEARED TOWARD MINORITY AND WOMEN OWNED

FIRMS AS SOCIAL ISSUES OR CHARITY. PLANS TO AID THESE FIRMS WILL CREATE GROWTH FOR THE NATION'S ECONOMY, JOBS FOR OUR CITIZENS, AND WILL HELP TO EXPAND OUR TAX BASE. ALL OF WHICH WILL BE A POSITIVE FACTOR IN OUR ATTEMPTS TO BRING THE MASSIVE FEDERAL DEFICIT UNDER CONTROL.

THE SOLUTIONS THAT HAVE BEEN PROPOSED SO FAR ARE A LEGITIMATE ATTEMPT TO SOLVE THE CREDIT PROBLEMS OF THE SMALL BUSINESS COMMUNITY. UNFORTUNATELY, I DO NOT BELIEVE THAT THE ACCESS TO CAPITAL ISSUE FOR MINORITY BUSINESSES HAS BEEN ADEQUATELY ADDRESSED. MINORITY BUSINESSES FACE SPECIFIC PROBLEMS OUTSIDE OF THOSE FACED BY MAJORITY FIRMS. I HOPE THAT DURING TODAY'S ROUNDTABLE WE CAN BEGIN TO DISCUSS THIS ISSUE. I THANK THE CHAIRMAN FOR HOLDING THIS IMPORTANT HEARING AND I LOOK FORWARD TO HEARING THE INSIGHTS OF OUR DISTINGUISHED PANELISTS.

STATEMENT FOR HEARING ON SMALL BUSINESS LONG-TERM FINANCING
THE HONORABLE MARJORIE MARGOLIES-MEZVINSKY
MAY 12, 1993

I would like to thank you, Mr. Chair, for holding this roundtable discussion today; this committee has heard from many policy experts on the issue of the "credit crunch" and I welcome the opportunity to hear from the practitioners -- those men and women who are directly affected by what we on Capital Hill do and do not do. I would also like to introduce you to one of my constituents, Ms. Suzanne Fairlie, from Conshohocken, PA, who will be testifying today.

In 1987, Ms. Fairlie founded a personnel consulting firm named ProSearch. The firm specializes in placing people in information systems jobs and works with Fortune 500 companies throughout the Delaware Valley region. ProSearch has carefully built its client base and has already earned a spot on the Philadelphia Business Journal's top 25 list of personnel search firms.

Ms. Fairlie also serves as the national board representative for the Greater Philadelphia Chapter of the National Association of Women Business Owners. Given the fact that women constitute an ever increasing percentage of small business owners, I am eager to hear Ms. Fairlie's testimony and to learn more about the particular problems which face women business owners -- especially the difficulties they face in accessing credit markets and obtaining needed capital.

Again, I thank the Chair for what I know will prove to be an informative discussion.

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5-12-93

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Testimony to House of Representatives

Committee on Small Business

by

Dr. Chester R. McKee

Chairman In-Situ Inc.

In-Situ Inc is an Environmental Monitoring Company which manufactures its' instrumentation in Laramie Wyoming. The instrumenstation is used on Hazardous Waste Sites and to monitor ground water and Surface water, and to monitor Underground storage tanks at gasoline Service Stations. We sell products to Fortune 500 companies such as Dupont and Exxon and over seas as well. - Recent sales to Taiwan Water Board British Petroleum in Singapore De Beers consolidated Mines in Botswana. and BHP in Australia.

5-12-93 (2)

Sales this coming Fiscal year are anticipated to be over $7 million. We employ 70 people, and have been in business for 15 years.

1. Began my career as a University Proffessor I didn't think much of Business men in those day. But having been in their shoes for 14 years I have come to appreciate and respect the responsibility we bear and the challenges over which we must prevail to succeed, most of which are created by our government

2. Growth averaged 30%/yr – Knew we would need more capital to grow.

Prepared by borrowing $200,000 secured against bank Certificates of deposit.

Paid loan down in 6 months

As we had 4 million in fixed assets ($500,000 in cash)

Went to our banker to borrow $500,000 to 800,000.

5-12-93
Page 3

Received Local Bankers Word they would grant the loan. Later said, even though an SBA guarantee for 80% of the Loan was forth coming, that they wouldn't grant the loan. even though I had personally guaranteed the loan & pledged Corp assets. After Pressure from a Wyoming agency they said they would grant the loan. (No good reason given) I became concerned that the loan decision wasn't being made locally, but rather in a different city or even another State, (by the parent bank,) and that the loan could be in called in - at the worst possible time. Our assets could be sold in a fire sale for a fraction of their worth, and the business closed down

Hence we decided to terminate some employees and "batten down the hatches." We are now growing at 5% / year instead of 30%/yr - but we're safe from the banks.

(over)

We have been to Venture Capital groups

Our Company is not a start up and we have

been told were a good fit for them. As to

Going public we are told by major underwriter

that we should be at $20 million in Sales,

and we were too small.

Veldasue could be useful but a partial Gov't

guarantee of say 30% would be useful


Product Catalog
In-Situ Inc.
The Solutions People

Dear Customers and Friends,

In-Situ Inc. designs and manufactures instrumentation regarded in the hydrologic, environmental, and petroleum industries as products of the highest level of quality, service, and value. In-Situ originated 16 years ago in Laramie, Wyoming, as a consultant to the in-situ mining industries active in the West. While our company has changed since then, our commitment to supporting the needs of our customers has not.

Another thing that has not changed is the question we hear the most, "Why Laramie, Wyoming?" The following pages answer that question The scenery is local to Laramie It should give you a sense of the quality of life that we enjoy, and how our commitment to protecting our environment translates into quality products for environmental monitoring applications and evaluations

Without the contribution of skilled people, quality products would not be created The employees of In-Situ know that their foremost duty to you is maintaining and improving the quality and value of the products and services we offer you

If you ever have any comments or suggestions, we would like to hear from you. We can't guarantee that our products will survive any field environment (see inset below), but we are striving for complete customer satisfaction

Much to our amazement this HERMIT which was run over by a rather large field service truck still works It can log and output data and tell time The only thing that it can t do is display information due to a cracked LCD Needless to say it has logged its last field duty

Product Catalog

Table of Contents

The HERMIT 2000 is a multi-channel, stand-alone data logger that can be used in an extensive array of hydrologic and environmental applications. Like all In-Situ instrumentation, the HERMIT 2000's state-of-the-art circuit design and quality electronic components make it compatible with the extreme environments that may be encountered in the field.

Applications

- Multi-well aquifer tests (both drawdown and recovery), including collection of fast, early-time drawdown data for constant- or stepped-rate tests.
- Field measurements of parameters such as level, flow, pressure, conductivity, and temperature, using In-Situ transducers and probes
- Unattended long-term monitoring of aquifers, lakes, streams, reservoirs
- Central control of a large monitoring network.
- Recording flow from orifice plate discharge pipes

Features

Portable, field-worthy construction: Completely self contained, requires no external programmer or PC. Weathertight even with the cover open. Waterproof and dust-proof Hughes connectors with double O-ring seals. Conformally coated circuit boards

Dependable, stand-alone operation: Long-life lithium battery functions over a wide temperature range. Delayed start capability for synchronizing multi-well tests, or collecting data in remote areas with limited seasonal access. Non-volatile memory so even if power is lost, the data isn't. Will not overwrite data, stops recording data when memory is full.

User-friendly instructions: Large LCD and simple keyboard for easy menu-driven programming. View, download, and plot data without stopping a test. 20 automatic self diagnostic checks each time the instrument turns on. Temperature-compensated low-battery indicator shows when approximately 10% of battery life remains.

Programmable functions: User-programmable reference level eliminates data conversion. Data recorded in user-selected English or Metric units. Preprogrammed standard logarithmic sampling or user-defined linear sampling. HI-LO alarm sets to signal an alarm condition or activate a switch.

Specifications

General

Dimensions 10" × 16" × 11" (25.4 × 40.6 × 28 cm)
Weight 20 lbs (10 kg)
Operating Temperature −40°C to +70°C (−40°F to +158°F)
Stability ±0.005% of full scale/°C
Input channels: 4, 8, 12, or 16
LCD 40 digit alphanumeric

Data Sampling

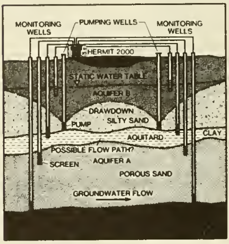
Memory Type. Non-volatile EEPROM
Memory Capacity 64K standard, expandable to 512K
Data Point Capacity: 32,000 standard, expandable to 256,000
Sampling Schedules
  Preprogrammed standard logarithmic sampling
  Linear Sampling in user-selected 2 seconds to 48 hours

Power Requirements

Battery Type Lithium
Expected Battery Life. Greater than 100,000 data points
External Power Option
  Input Voltage, +12 VDC to +18 VDC (+13.8 VDC nominal)
  Input Current: 50 mA typical, 500 mA peak

Communications

RS232 Interface
  Baud Rate Selectable, 300 to 9600
  Character Rate. Selectable, 7 or 8 bits
  Parity. Selectable; even, odd, or none
HI/LO Alarm Contact: 30 VDC or 30 VAC Max



HERMIT 1000C

The compact, two-channel HERMIT 1000C Data Logger is designed and built to operate reliably in extreme conditions – from a cold, wet winter site to a hot, dry desert site. The 1000C Data Logger collects and stores water level and water quality data with a 32K non-volatile memory. All components of the 1000C are engineered and tested to insure consistent, accurate performance in the field, allowing data collection without costly interruptions.

Applications

- Slug tests, single- and dual-well pumping tests
- Water level monitoring of surface and groundwaters, including flowing artesian wells
- Remote monitoring in areas with limited access
- Water quality monitoring

Features

Portable, field-worthy construction: Completely self contained, requires no external programmer or PC. Weathertight even with the cover open. Waterresistant and dust-proof connectors with double O-ring seals. Conformally coated circuit boards.

Dependable, stand-alone operation: Long-life lithium battery or alkaline battery available to fit your specific needs. Delayed start capability for synchronizing multi-well tests, or collecting data in remote areas with limited seasonal access. Temperature-compensated low-battery indicator shows when approximately 10% of battery life remains.

Programmable functions: User-programmable reference level eliminates data conversion. Data recorded in user-selected English or Metric units. Preprogrammed standard logarithmic sampling or user-defined linear sampling. HI-LO alarm can be set to signal an alarm condition or activate a switch.

Specifications

General
Dimensions. 7" × 9" × 11" (18 × 23 × 28 cm)
Weight: 12 lbs (5.5 kg)
Accuracy: ±0.06% of full scale (at constant temp.)
±0.2% of full scale (includes temp. effects)
Stability: ±0.002% of full scale/°C
Input channels: 2
LCD: 5 digit alphanumeric

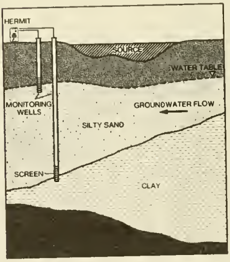
Data Sampling
Memory Type: Non-volatile EEPROM
Memory Capacity: 32K
Data Point Capacity: 16,000
Sampling Schedules:
Preprogrammed standard logarithmic sampling
Linear Sampling in user-selected 2 seconds to 48 hours

Power Requirements
Battery Type: Lithium
Operating Temperature: -40°C to +70°C (+40°F to +158°F)
Expected Battery Life: 100,000 data points or 3 yrs. over the specified temperature range

Battery Type: Alkaline
Operating Temperature: −10°C to +40°C (+14°F to +104°F)
Expected Battery Life: 100,000 data points or 2 yrs. over the specified temperature range

External Power Option: Input Voltage, +12 VDC to +18 VDC
Input Current: 20 mA typical, 250 mA peak

Communications
RS232 Interface
Baud Rate: Selectable 300 to 2400
Character rate: Selectable 7 or 8 bits
Parity: Selectable odd, even, or none
HI-LO Alarm Contact: 30 VDC or 30 VAC Max



The Well Sentinel is a practical, hard-working, single channel data logger for monitoring water level in hydrologic and environmental applications. This rugged, inexpensive instrument is designed specifically for long term use. All components of the Well Sentinel are engineered and tested to insure consistent, accurate performance in the field

Applications

- Unattended long-term water level monitoring of aquifers, lakes, ponds, streams, and waste disposal sites
- Tidal monitoring
- Surface waters

Features

Portable, field-worthy construction: Completely self-contained, weathertight, and does not require special housing. Water-resistant and dust-proof connectors with double O-ring seals. Conformally coated circuit boards.

Dependable, stand-alone operation: The electronic components function over a wide temperature range. Delayed start capability for collecting data in remote areas with limited access. Fits into 4" Schedule-80 PVC well casing. Can rapidly download to create standard ASCII data files using IBM PC or compatible

Programmable functions: User-programmable reference level eliminates data conversion. Data recorded in user-selected English or Metric units. User-defined sampling interval

Specifications

General

Dimensions. 3.75" diameter, 23.75" length (9.53 × 60.33 cm)
Flange. 4.5" diameter, 0.5" length (11.43 × 1.27 cm)
Weight: 8.5 lbs. (3.8 kg)
Accuracy: 0.04% over operating temperature range
Resolution: 0.01% over operating temperature range

Data Sampling

Memory Type: Non-volatile (EEPROM) with data retention 10 year minimum
Memory Capacity: 32K standard, 64K expanded (up to 32,768 data points)
Sampling Interval: 1 minute to 12 hours

Power Requirements

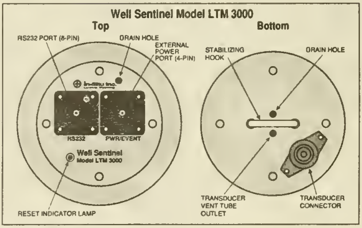
Battery Type: Lithium
Operating Temperature: -40°C to +70°C (+40°F to +158°F)
Expected Battery Life: One million data points or 5 yrs. over the specified temperature range

Battery Type: Alkaline
Operating Temperature: -10°C to +40°C (+14°F to +104°F)
Expected Battery Life: One million data points or 2 yrs. over the specified temperature range

External Power Option. Input Voltage, +12 VDC to +15 VDC
Input Current: 150 mA maximum

Communications:

RS232 Interface
Baud Rate. 9600
Character Rate: 8 bits
Parity. None



The transducers we sell provide accurate, stable, long-term monitoring in field environments. We take our published specifications seriously, and in some cases, the actual product specification exceeds what we publish Calibration documentation is provided with all pressure transducers

PXD-260

The PXD-260 is a fully-submersible pressure transducer that provides accurate and reliable water depth measurements Designed and manufactured by In-Situ, the PXD-260 incorporates an integrated silicon strain gauge bridge into a factory-repairable design Available on Teflon or polyurethane cable The cable is vented to the atmosphere to allow the transducer to compensate for fluctuations in barometric pressure

PTX-1610

The PTX-1610 simplifies water depth measurements in aquifers, reservoirs, streams, lakes, and other water bodies The transducer's small diameter allows it to fit in drop pipes as small as 3/4" A tough, resilient polyurethane-sheathed cable is attached to the body with a high integrity waterproof assembly, the cable is vented to allow for compensation of barometric pressure

PXD-360

The PXD-360 Barometric Pressure Transducer provides an accurate measurement of absolute pressure in the 8 PSIA to 16 PSIA range Software coefficents are provided to display pressure in PSIA Conversion factors are available to display results in mm Hg inches H_2O, and inches Hg, to name a few

Specifications	PXD-260	PTX-161D	PXD-360
Wetted materials	316 Stainless steel, Teflon	Titanium, quartz, Delrin silicon RTV, neoprene stainless steel	316 Stainless steel Teflon
Dimensions	1" Diameter / 10 9" Length (25 4mm / 277mm)	0 69" Diameter / 8 5" Length (17 5mm / 216mm)	1" Diameter / 10 9" Length (25 4mm / 277mm)
Weight	1 50 lbs (68kg)	4 oz (12kg)	1 50 lbs (68kg)
Output	4-20 mA	4-20 mA	4-20 mA
Ranges	10, 15, 20, 30, 50, 100, and 250 psig	10, 20, 30, 50 100, and 300 psig	8 PSIA to 16 PSIA
Overpressure Tolerance	2× full range or 450 psig (whichever is less)	2× full range	32 PSIA
Accuracy with HERMIT 1000C or with HERMIT 2000	±0 05% of range	±0 05% of range	±0.05% of range
Stability	±0.005% of full scale/°C	±0 005% of full scale/°C	±0 005% of full scale/°C
Operating Temperature	+14°F to +176°F (-10°C to +80°C)	-4°F to +176°F (-20°C to +80°C)	+14°F to +176°F (-10°C to +80°C)
Cable Wetted Materials Maximum Length	Polyurethane or Teflon 4500'	Polyurethane only 4500'	Polyurethane or Teflon 4500'

Teflon and Delrin are registered trademarks of E I DuPont de Nemours Company

PROBES

10

pH/Conductivity Probes

The pH and Conductivity Probes were designed for use with In-Situ's HERMIT Data Loggers, and can monitor various field applications with resolutions and accuracies associated with the best laboratory instruments. Both are "dual-mode" probes, and are calibrated by software coefficients supplied with each probe. With the unique patented electronic stabilization technique the probes maintain the accuracy of the measurement independent of temperature or variation in probe electronics. The small diameter of both probes, (1.5") permits access to monitor wells with 2" I.D casing. Both the pH Probe and the Conductivity Probes can be used to monitor aquifers, lakes, streams and rivers, and other water bodies. The pH and Conductivity Probes can be ordered with polyurethane or Teflon cable

pH Probe

Applications

The pH Probe (PHX-100) measures temperature and temperature-compensated pH simultaneously using one input channel on the HERMIT.

Features

- Isothermal point and probe output versus pH and temperature are individually determined for each probe to permit accurate measurements over the specified temperature range
- Design includes a replaceable combination probe element and interface electronics
- Temperature and pH time constants are matched to permit compensation under normal temperature variations

Specifications

Wetted Materials. 316 Stainless Steel, Teflon, pH glass
Dimensions. 1.5" diameter × 22" length (3.8 × 56 cm)
Weight 4.9 pounds (2.2 kg)
Pressure Rating 150 psi maximum

Conductivity Probe

Applications

The Conductivity Probe (CTS-100/OH) measures both conductivity and temperature simultaneously using only one input channel on the data logger.

Features

- The data logger displays the temperature of the solution in addition to temperature-compensated or uncompensated conductivity measurements.
- Unique signal system permits long cable lengths (up to 1000') without reduction in accuracy.
- The sensing circuitry can compensate for probe contamination and for component variations due to aging and temperature.
- For increased range, two restrictors are supplied with each probe; usage depends on the expected conductivity of the solution being measured.
- The probe's elements are field serviceable by removing the restrictor and cleaning the sensing elements.

Specifications

Wetted Materials. 316 Stainless Steel, Teflon
Dimensions 1.5" diameter × 16.8" length (3.8 cm × 42.7 cm)
Weight: 4.7 pounds (2.1 kg)
Pressure Rating 400 psi maximum

Range, Accuracy, Resolution

		Conductivity (microSiemens/cm)			pH			Temperature (°C)		
Model	Restrictor	Range*	Accuracy 0.5% FS	Resolution 0.02% FS	Range	Accuracy**	Resolution	Range	Accuracy	Resolution
CTS-100/OH										
Type 1	K2	0-1.000	±5	0.2				0°-50°	±0.2°	0.01°
	K20	0-10.000	±50	2						
Type 2	K2	0-10.000	±50	2						
	K20	0-100.000	±500	20						
Type 3	K2	0-100***	±0.5***	0.02***						
PHX-100					2-12	±0.1pH unit	0.005			

*Uncompensated full-scale range
**5°-35°C, 4-10 pH including temperature compensation
***The Type 3 probe reads in milliSiemens/centimeter

Teflon is a registered trademark of E.I. DuPont de Nemours Company

PROBES

Leak Detection Systems

In-Situ's Leak Detection Systems provide continuous, external monitoring for underground storage tank systems. A unique, patented sensing technology, in a practical and easy to maintain system, provides round-the-clock protection for the environment and your investment The systems feature a closed-circuit design which is activated by the interaction of the sensor with petroleum products Several different monitors can be connected to the Remote Station consoles

Monitoring Well Installations
The KW-240 (see inset opposite page) can monitor for petroleum products in the entire well continuously, regardless of groundwater fluctuations The monitor fits in the top of the well casing and the sensing assembly is suspended in the well When the sensor contacts liquid- or vapor-phase petroleum products, it breaks, triggering an alarm at the Remote Station console

The KW-140 Monitor is identical to the KW-240, but does not require a Remote Station, as alarm status is determined by visual inspection of the Monitor.

Sump Monitoring
The KW-240 with Float Option detects fluid presence, typically in a sump. The monitor fits in the top of the casing or riser with a float mechanism When the weighted float becomes buoyant in the presence of fluid, it activates the alarm system.

Interstitial Monitoring
The KW-241 Monitor (top right), designed for monitoring the dry interstitial space of double-wall tanks and piping, can detect water, petroleum products, and waste oil entering the space The KW-242 (middle right) monitors the interstitial space of tanks and piping, detecting petroleum products and waste oil only The KW-242 is not affected by condensation in the interstitial tank space.

Both monitors fit in the top of a riser, the drop pipe in the end of a tank, or the curved annular space in a tank or piping. Chemical interaction of vapor- or liquid-phase products with the sensing element activates the alarm at the Remote Station console.

Remote Stations
The Remote Stations (bottom right) are central alarm consoles which relay the status of the Monitor with audible and visual alarms Two different models of the Station are currently available, depending on your particular application The Model RSS supports 3 Monitors, and the model RSE supports 8 Monitors. The newest Remote Station, the model RSP, is a programmable console that supports 16 monitoring units

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Lab In A Bag

Lab In A Bag is a field-worthy, commercial version of the Polyethylene Bag Sampling System for dynamic headspace analysis. Lab In A Bag meets EPA- approved guidelines as an interface between soil and water samples contaminated with VOCs and a total organic vapor detector (TOVD), providing the critical edge over previous headspace sampling systems.

Why The Bag? Other systems frequently use a rigid container for headspace sampling of soil or water. If these containers are unsealed, they cause dilution of the vapors with an indefinite quantity of ambient air. If they are sealed, they inhibit the flow of vapors to the TOVD, interfering with the measurement. Lab In A Bag provides a cost-effective field screening method using an inert, sealed container of reproducible volume which maintains constant atmospheric pressure Lab In a Bag's reliability has been demonstrated by corroboration of field VOC measurements in the laboratory.

Applications

- Enables quick assessments of level and extent of contaminants for both initial site investigation and subsequent remediation efforts
- Overcomes problems of sample deterioration that occur with delayed lab analysis
- Adapts to numerous measuring devices including FIDs and PIDs

Features

Portable, field-worthy construction: Two lead-acid batteries to power the inflating pump and magnetic stirrer. Battery charger for overnight recharging A single charge gives you a 200 sample capacity. Carrying case for easy transport and field accessibility.

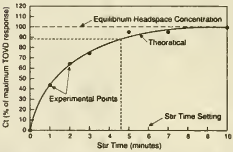
Accessories

- Complete instructional manual for using Lab In A Bag
- 100mL volumetric flask used in preparation of standards
- 25µL variable volume micropipet used in preparation of standards
- Truncated polyethylene syringe and steel "scoopula" for collecting soil samples
- Teflon covered stir bar for agitation of samples in bag
- Instructional template with easy to follow step-by-step instructions

Specifications

General Dimensions. 10.5"H × 7.25"D × 6.5"W
(27.7 cm × 18.4 cm × 16.5 cm)
Total Weight 8 lbs. (3.6 kg)
Materials. Aluminum, epoxy, brass, Tygon, fiberglass
Operating Temperature +1°C to +40°C (+33°F to +104°F)
Battery: Rechargeable lead-acid
Expected Life Typically 200 measurements on a full charge
Timer 1 to 11 minutes in 1 minute increments
Pump Speed 2.2 liters/minute
Carrying Case. 23.25"L × 20.75"W × 9"H, heavy-duty and waterproof

Tygon is a registered trademark of Norton Co
Teflon is a registered trademark of E I DuPont de Nemours Company



Sample plot of TPVD Response vs. Lab In A Bag Stir Time showing that each sample needs a minimum of 5 minutes stir time.

Accessories

Levelhead

The In-Situ Levelhead is a low-cost, hand-held instrument designed for field water-level measurement with pressure transducers The Levelhead is ideal for applications that require stationary downhole transducers It can be used sequentially with a large number of transducers since it attaches and detaches so easily Two models are available model LH10HM displays in SI units, model LH10HE in English units

Field Printers

Two models of field printers are available for conveniently printing data recorded by any of In-Situ's data logging systems Instruments with graphics capabilities such as In-Situ's HERMIT 2000 can even utilize the printers as field plotters The Model SE1004B is a durable, compact field printer The Model GFP-80 (pictured at left) is a HP-Thinkjet printer that is repackaged in a portable field case

Shipping Containers

Approved by the US Dept of Transportation, In-Situ's shipping containers are water-tight, pressure-tight to 0 5 psi, have sturdy and comfortable carrying handles, and can easily support a person's body weight for use as a seat in the field There are five different models of containers to meet the needs of the most common combinations of instrumentation

Cable Splice

The CS-265 Cable Splice is a submersible in-line Teflon-to-polyurethane cable splice for use with In-Situ's probes This accessory makes it easy to change from polyurethane to Teflon cable when using a probe in a monitoring application where contaminants are likely to be present It eliminates the need for a drop pipe or other enclosure to provide cable protection It also enables the placement of probes below packers in wells

Teflon is a registered trademark of E I DuPont de Nemours Company

Extent of Warranty

All In-Situ instruments listed herein, excluding batteries, probes, and Leak Detection Systems, are warranted against defects in materials and workmanship under normal operating conditions for two years from the date of delivery

All In-Situ pressure transducers and probes are warranted against defects in materials and workmanship under normal operating conditions for one year from the date of delivery

All In-Situ Monitors and Remote Stations are warranted against defects in materials and workmanship for a period of one year from date of purchase, provided the equipment has been installed according to the manufacturer's instructions and diagrams.

Rental Equipment

In-Situ's Data Logging Systems can be rented and a portion of the rental fee applied as purchase credits toward purchase of a new HERMIT or Levelhead system Credit may be applied to a percentage of the total purchase price. Customers must pay invoiced rentals within thirty (30) days to earn purchase credits which expire within one year of the rental invoice date.

Technical Services

Upon request, In-Situ Inc will make technical field personnel available to customers at a daily rate charge plus travel expenses at cost Customers may choose to send personnel to our facilities for training and orientation in equipment use. In-Situ Inc. will provide this service at no charge

Calibration & Certification

All In-Situ products are guaranteed to operate within published specifications at the time of sale, and any product receiving maintenance is returned to the customer within those same specifications We take our published specifications seriously, and in some cases, the actual specification exceeds what we publish. Calibration documentation is provided for data loggers and probes.

Disclaimer

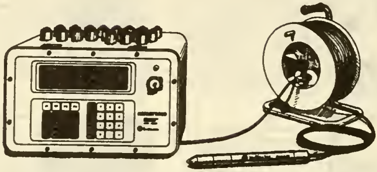
Due to continuing product development, In-Situ reserves the right to alter specifications without prior notice.

Federal Supply Schedule

Selected In-Situ products are included for sale under Federal Supply Schedule guidelines. For prices and additional information contact In-Situ Inc.

In-Situ Inc.

September 1992 Price List



All prices in U.S. $

Data Loggers

HERMITs
Purchase price of HERMITs includes internal lithium battery, external power package (AC and cigar lighter adapter), RS232 interface package, HI/LO alarm and cable, Operator's Manual, Pocket Guide and Data Transfer software.

HERMIT 1000C (Model SE1000C)
2 Channel with 32K Memory 3,500
Extra Operator's Manual 50

HERMIT 1000B to HERMIT 1000C Upgrade
Includes 32K non-volatile memory, new software, service fees, new Operator's Manual, Pocket Guide 730

HERMIT 2000 (Model SE2000)
4 Channel with 64K Memory 5,900
8 Channel with 64K Memory 6,900
16 Channel with 128K Memory 9,700
Extra Operator's Manual 50
Additional 64K Memory 1,653.75
Additional 4 Channel 1,548.75

HERMIT Replacement Accessories
Replacement Lithium Battery (installed): *Includes software upgrades, recalibration, engineering upgrades and operational checks* 500
120 VAC External Power Supply 75
120 VDC Cigar Lighter Adapter 75
Panel Mount Connector Kit 35
General Purpose RS232 Interface Cable 100

Well Sentinel (Model LTM 3000)
Single-channel data logger for long-term monitoring. Requires a computer. Accessories includes 32K non-volatile memory, carabiner, non-sealing monitor cap, Operator's Manual, and SituCom software.
Alkaline Battery Well Sentinel With Accessories 1,295
Lithium Battery Well Sentinel With Accessories 1,695

The Power & Communication Package: Includes a 120 VAC to 15 VDC wall-mount external power pack, 12 VDC automobile cigar lighter adapter, serial interface cable, and 9-pin to 25-pin adapter 100

The Well Protection Package: Includes a 4" locking well cap to protect against fluid entry into the well 100

Well Sentinel Accessories
2" to 4" Adapter 15
Mounting Kit 5
External Power Supply 75
Serial Interface Cable 25
Additional 32K Memory 157.50

Lab In A Bag
Purchase includes internal lead-acid battery, external power package, Operators's Manual and instructional Template for cutting holes in bags with brief operating summary printed on template. $1,495.00

Lab In A Bag Package
Includes basic accessories, Labware and Carrying Case. $1,995.00

Business Hours: Monday-Friday 7am-5pm MST
Price list subject to change without notice.

In-Situ Inc., P.O. Box I, Laramie, WY 82070-0920
1-800-446-7488, FAX (307) 721-7598

Probes

Pressure Transducers
Druck Pressure Transducer (Model PTX-161D)
Standard Ranges 1,150
Special Ranges 1,350
In-Situ Pressure Transducer (Model PXD-260)
Standard Ranges 995
In-Situ Barometric Pressure Transducer (Model PXD-360)
on 25 ft polyurethane cable 1,100
on 50 ft polyurethane cable. 1,143.75

Pressure Transducers Complete with Cable Assembly
These are standard configurations, consisting of polyurethane cable @ 1.75/ft, cable reel & 15 ft jumper cable.

Cable Length	PXD-260 10,15,20,30,50 psi	PXD-260 100 psi	PTX-161D 10,20,30,50 psi	PTX-161D 100 psi
150 ft	$1,355	--	$1,510	--
250 ft	$1,530	--	$1,685	--
300 ft	--	$1,620	--	$1,775
400 ft	$1,795	$1,795	$1,950	$1,950
500 ft	--	$2,020	--	$2,175

Pressure Transducer Accessories
Junction Vent Box (Model JVB 100) 250
JVB 100 with 15 ft jumper cable 295
The Plopper 2" or 4" Diameter (Model AWL 100) 190
Plopper with measuring tape available, contact your In-Situ sales consultant for current price
Pressure Adapter (Model XD1AB) 75
Protective Coating (Flourosilicate), 2 oz. tube 30
Jumper Cable, 15ft. 80
Heavy-Duty Extension Cable, 50 ft 150
Wellcap Cable Holder 20
Universal Connector Kit. 35
Kellems Grip 15
Speed Bump Cable Protector (6 ft) 337.50
Additional lengths available, contact your In-Situ sales consultant

Water Quality Probes
In-Situ Conductivity Probe (Model CTS-100/DH)
Type 1 (low to mid-range) 1,795
Type 2 (mid to high range) 1,795
In-Situ pH Probe (Model pHX-100) 1,295

Water Quality Probes Complete with Cable Assembly
These are standard configurations, consisting of polyurethane cable @ $1.75/ft, cable reel & 15 ft jumper cable.

Cable Length	Conductivity Probe	pH Probe
250 ft	$2,130	$1,830
400 ft	$2,395	$2,095

Cable

Polyurethane Cable
per foot 1.75
per meter 5.75
Teflon Cable (not available with the Druck Transducer)
per foot 3.00
per meter 9.85
Extension Cable, 400 ft polyurethane on ABS plastic reel 850
Cable Splice Kit (Model CS265 KIT), installed 367.50
Cable Reels. *Each reel includes 15 ft jumper cable if purchased with downhole cable.*
ABS Plastic, 400 ft capacity 100
Small Steel, 500 ft capacity 150
Large Steel, 1500 ft capacity 200

Accessories

Printers
Field Printer (Model SE1004B) 550
Includes 120 VAC/12 VDC power adapter, 12 VDC lantern battery cable, and 12 VDC cigar lighter power adapter. The following accessories may be purchased separately:
Printer Paper, box of 5 rolls 5
Printer Ribbon 8
120 VAC/12VDC power adapter 25
12 VDC lantern battery cable 5
12 VDC cigar lighter power adapter 5
Graphics Field Printer (Model GFP-80) 1,100
Includes RS232 cable, spare ink cartridge, 500 sheets paper.

Shipping Containers
All shipping containers are weatherproof and approved by the Department of Transportation. In-Situ recommends them for shipping and storing our HERMIT Data Loggers and accessories.

Model	Configured to hold:	Price
1KPO	HERMIT 1000, SE1004B Printer	$325
1KP1	HERMIT 1000, SE1004B Printer, 1 Transducer	$375
1KP2	HERMIT 1000, SE1004B Printer, 2 Transducers	$425
2KPO	HERMIT 2000, SE1004B Printer	$475
4XD	4 Transducers	$525

For More Information call 1-800-446-7488

In-Situ Inc. was founded in Laramie, Wyoming in 1976.

Terms & Conditions

Warranty
Products manufactured and sold by In-Situ come with warranties. The operator's manual for each instrument or probe includes a warranty section which describes the specific warranty that applies to the product sold.

All In-Situ instruments listed herein excluding batteries, are warranted against defects and materials in workmanship under normal operating conditions for two years from the date of delivery.

All In-Situ probes are warranted against defects in materials and workmanship under normal operating conditions for one year from the date of delivery.

In-Situ will repair, or, at its option, replace at no charge, components that have proven to be defective during the period of warranty, provided the instrument is shipped, prepaid, to In-Situ's Product Service Facility. Contact In-Situ's Product Service Department for shipping instructions prior to shipping.

These warranties do not apply if the instrument has been damaged by accident or misuse, or as a result of service or modification by other than In-Situ personnel.

No warranty of fitness for any particular purpose nor any other representation or warranty, whether express or implied, is made respecting products sold or leased, and there are no warranties which extend beyond the description of the product in the operator's manual.

Customer's exclusive remedy with respect to any products sold or leased by In-Situ that are found to be defective or otherwise not in conformity with any warranty shall be limited to the right to replacement thereof or to repayment of the price of the products sold or leased.

In no event shall In-Situ be liable for personal injury, property damage, loss of profit, delay, or any incidental or consequential damages whether arising from contract, breach of contract, tort, In-Situ's negligence, strict liability or any express or implied warranty, including, but not limited to implied warranties of merchantability or fitness for a particular purpose.

Terms & Conditions

Prices
Prices include standard packaging in accordance with carrier requirements. Shipping and handling charges are additional. Prices are subject to change without notice and we reserve the right to discontinue any items without notice. Applicable federal, state, and local taxes are extra.

Many of In-Situ's products are covered by GSA contracts. GSA price schedules are available for qualifying orders.

Customer Accounts
In-Situ is pleased to extend terms of net 30 days to customers who have established an open account with us. If you wish to open a new account, a credit application is available. A bank reference and four trade references are required.

Rental customers must sign and return an Equipment Rental Agreement.

Orders
All orders must be accompanied by a purchase order or full payment. Telephone orders must be accompanied by written confirmation (facsimile is acceptable). Custom orders require 21 working days.

In-Situ reserves the right to require a down payment or prepayment if the customer's account is not open or current.

Returns
If any returns are required, contact our Product Service Department for a return authorization and shipping instructions.

Orders cancelled after shipment are subject to a restocking fee of 10% of the order price. Items returned must arrive at In-Situ within 10 days and remain unopened in the original packaging. Custom orders may be subject to a cancellation fee of the full purchase price. Return approvals will be issued a Return Materials Authorization (RMA) number. This number must appear on the outside of all parcels containing returned merchandise. All freight must be prepaid by the customer. All accepted returns will be credited to the customer's account. Refunds will not be issued.

Payments
Payments are due in 30 days from date of invoice. In-Situ welcomes all prepaid orders, which receive a 2% discount, as long as the account is current. Overdue balances will be charged 1-1/2% per month (18% annual percentage rate).

The customer agrees to pay all collection costs and penalty charges if collection services on the account become necessary.

Shipment
All shipments are sent either Federal Express or U.P.S. depending on customer requests. International orders are shipped by air unless otherwise requested. All shipping costs are paid by In-Situ and later billed to customer.

We package all products to meet the carrier's requirements. Equipment is checked prior to shipping and leaves In-Situ in operating condition. Please examine all shipments immediately upon receipt. Notify us in the event of shortage or damage. We will advise and assist in any claims to the carrier. All claims should be made within 10 days.

We are not responsible for delays due to strikes, accidents, carrier, or other problems beyond our control.

Calibration & Certification
Calibration documentstion is provided for Data Loggers and Probes.

Disclaimer
Due to continuing product development, In-Situ reserves the right to alter specifications without prior notice. We also reserve the right to alter terms prior to acceptance of the order.

Rental Rates

	Daily Rate Week 1	Daily Rate Weeks 2 & 3	Daily Rate After Week 3	Monthly Rate
HERMIT 2000 Data Logger 16 Channel (128K)	170.00	120.00	100.00	3,000.00
HERMIT 2000 Data Logger 8 Channel (64K)	115.00	80.00	66.67	2,000.00
HERMIT 1000C Data Logger 2 Channel (32K)	57.00	40.00	33.34	1,000.00
Well Sentinel Data Logger 1 Channel (32K) with pressure transducer on 50' or 100' cable	57.00	40.00	33.34	1,000.00
Well Sentinel Data Logger 1 Channel (32K)	40.00	29.00	20.00	600.00
Pressure Transducer with 400' or 500' cable, reel & jumper cable	35.00	25.00	20.84	625.00
Pressure Transducer with 1000' cable, reel & jumper cable	50.00	35.00	25.00	750.00
Barometric Pressure Transducer with 25' or 50' cable	35.00	25.00	20.84	625.00
Conductivity or pH Probe with 400' cable	45.00	30.00	23.34	700.00
Junction Vent Box	7.00	5.00	5.00	150.00
Field Printer-24 column	10.00	10.00	5.00	150.00
Graphics Field Printer 80 column	20.00	20.00	10.00	300.00
Extension Cable 400' on ABS plastic reel	10.00	10.00	5.85	175.00
The Plopper	7.00	5.00	5.00	150.00
Speed Bump Cable Protector	15.00	11.00	9.00	270.00

Rental Terms

Accessories
Rental price of HERMIT Data Loggers includes RS232 interface cable, operator's manual, pocket guide, Data Transfer software, and internal lithium battery. HERMIT 1000C is also available with internal alkaline batteries.

Monthly Rates
Monthly rates are invoiced in advance when the instrumentation is shipped. A minimum of one month is charged, even if less time is used. Rates for longer than one month are billed at 1/30th the monthly rate per day.

Rental Period
The rental period starts on the second business day following the day the equipment is shipped to a customer-designated location and continues until the return arrival of the equipment in Laramie, Wyoming. Customers are not charged for the day that the equipment reaches our facility. The minimum rental period is 3 days.

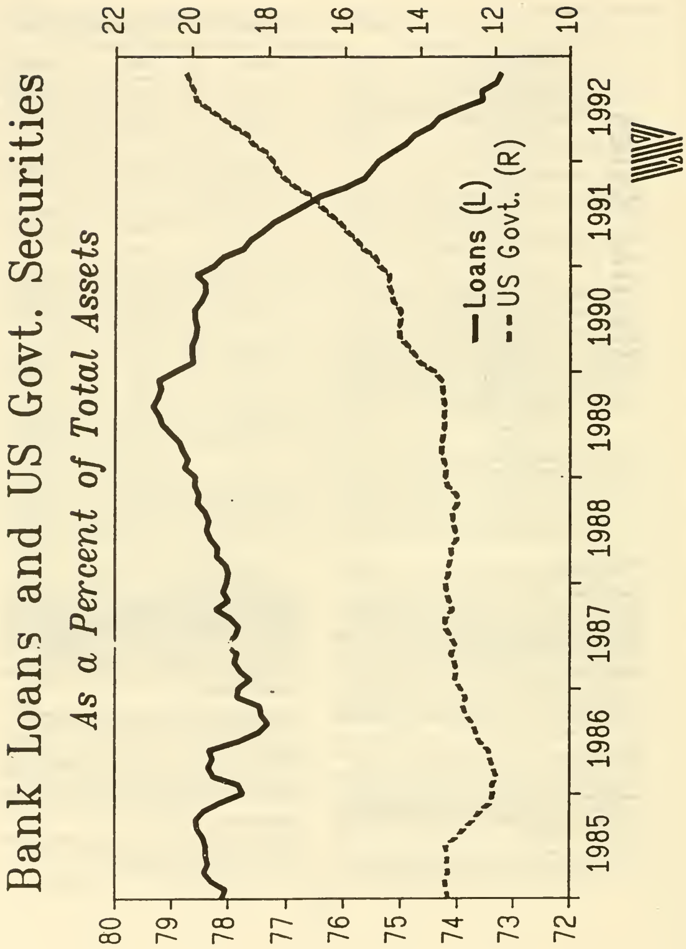
For More Information call 1-800-446-7488

Credit Toward Purchase
Companies renting In-Situ instrumentation earn a purchase credit of 20% of the time charge if the invoice is paid within 30 days. This credit may be applied toward purchase of new HERMIT system or Levelhead system. A system consists of a Data Logger or Levelhead and a probe. Credit may be applied up to 20% of the total purchase price. Purchase credits must be used within one year of the rental invoice date.

In order to earn purchase credit, customers must pay invoiced rentals within thirty (30) days.

Shipment
The customer is responsible for shipping charges in both direction. All instrumentation is examined, checked, and cleaned prior to shipment to assure performance.

Cancellation Fee
Customers who cancel a rental order after the equipment has been shipped will be charged a cancellation fee amounting to 2 days rental of the equipment plus shipping charges.


Bank Loans and US Govt. Securities
As a Percent of Total Assets
80
79
78
77
76
75
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73
72
22
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14
12
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1985
1986
1987
1988
1989
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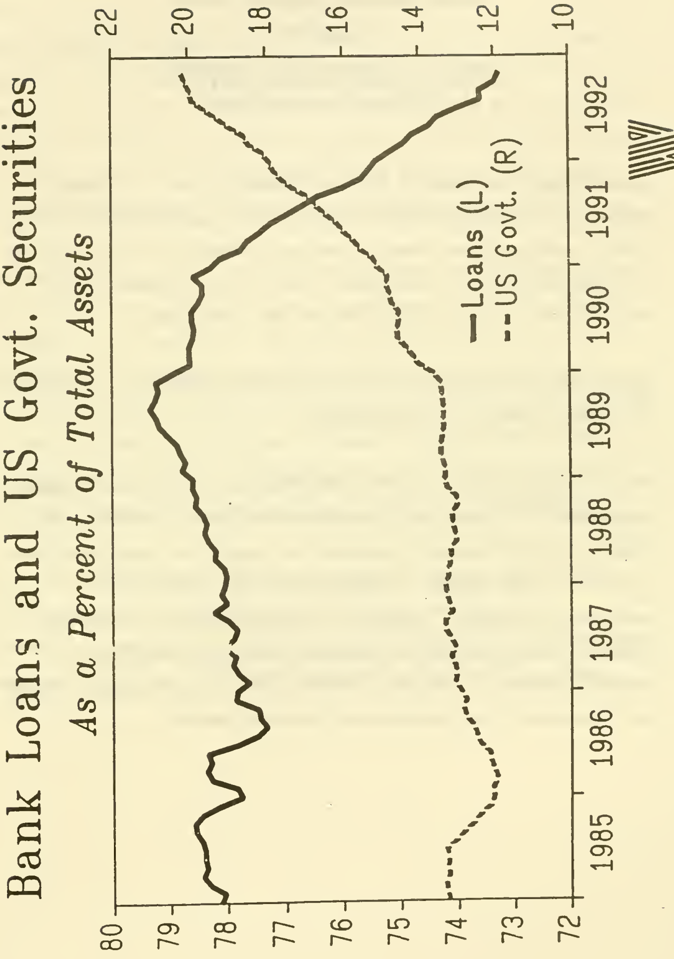
1992
Loans (L)
US Govt. (R)


Bank Loans and US Govt. Securities
As a Percent of Total Assets
80
79
78
77
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75
74
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22
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16
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12
10
1985
1986
1987
1988
1989
1990
1991
1992
Loans (L)
US Govt. (R)

SMALL BUSINESS FINANCING NEEDS

STATEMENT

William J. Pinkerton, President
Project Services International, Inc.
Pittsburgh, Pennsylvania

Good Morning. My name is William Pinkerton, and I sincerely appreciate the opportunity to address this committee here today. I am a small business owner in Western Pennsylvania and I am one of those who has had a difficult time obtaining credit at a critical time in the building of my small business.

First, let me explain a little of what my company is, and does, in a very competitive marketplace.

We are, by and large, a labor and knowledge-asset based company, as opposed to a plant and equipment-asset based company. We supply "facility support services" to industrial facilities both in the U.S. and abroad. These services are comprised of engineering services, industrial training, quality assurance programs, plant testing and commissioning, and industrial software systems. Our only financing is a line of credit, based on receivables, and backed by my personal assets.

Case 1:

Approximately two years ago we perceived a need in the Corpus Christie area of Texas for a plant equipment refurbishment shop facility (to repair valves and instrumentation in the many petrochemical and refinery plants in the area). We had some cash from generated profits but knew that it would take some time, and considerable expense, to establish ourselves in that area.

We approached our bank, with whom we had been doing business for approximately eight years, and explained the situation to them, backing up our plans with a well-written course of action and projections, which explained that we might run short of funds before the facility became completely established in the area and became profitable. Our banker indicated understanding of the situation and further, that the bank would "back" us, that is, provide funding in the way of a loan, when and if necessary.

Over the next several months, we invested our own funds in the venture and, as we had thought, found that we would need additional funding to continue, although workload at the facility was just beginning to increase and was showing great promise.

As planned, we again approached our bank and asked for a loan, aside from our line of credit which, as stated, was backed by receivables and personal assets. To our amazement, we were turned down, with the explanation that, "Money is tight right now; we're just not making loans at this time." When pressed, our banking agent told us that regulations on banks had made it very difficult to make loans, especially to small businesses, and that money was not available. In fact, lending authority had "moved up one step", and our agent didn't even have the authority to lend any longer.

The end result of this unexpected stance taken by our banker was the closure of our facility in Corpus Christie, the layoff of the eight people we had hired to work at the facility, and the loss of our own investment of approximately $200,000 dollars. We have survived, but the loss has since greatly hampered our ability to grow.

Case 2:

We recently approached another bank to attempt to obtain SBA-backed financing to be used as working capital, both in the development and marketing of industrial interactive multimedia

training programs and an industrial maintenance management software program which we have already developed, again through utilization of generated profits.

Our request was presented to a joint meeting of bank lending officers and local SBA representatives in February of this year and, although the bank has indicated that they might be willing to loan money if my own personal assets, along with the personal assets of my two junior partners, are pledged and are sufficient to cover the loan, neither the bank nor the SBA representatives held out much hope that a "SBA-backed loan" that we hear so much about would be made available. This loan request, by the way, was also accompanied by a well-done (or so we thought), business plan, which I have here with me today.

Chairman LaFalce, and members of the Committee on Small Business, I applaud your efforts in introducing the Velda Sue legislation. We in Small Business need, above all things, continuity and predictability in the availability of financing, if we are to continue to be the engine of job creation, as we have been in the past. Velda Sue could be an important small business credit market underpinning.

However, we need to go further. Under Velda Sue, for example, service-oriented businesses would not benefit, despite being a leading contributor to the growth and development of what is shaping up to be a "knowledge-based economy.

Banks must be placed within a regulatory environment where amall business financing is a key continuing component of their business. Making money by investing in U.S. Treasuries is not, or should not be, the bank's role in the economy.

Finally, many of us in Small Business believe that a Plant and Equipment based program, although being a great start, could leave many of us short by introducing a lending bias towards "hard goods", and may penalize high-tech and engineering-oriented companies that are, in fact, creating a large portion of jobs and export earnings.

Thank you very much for this opportunity to present these views to the Committee.

William J. Pinkerton
President, Project Services International, Inc.
Chairman, TEC/Pennsylvania Small Business United

CONGRESS OF THE UNITED STATES

COMMITTEE ON SMALL BUSINESS

ROUNDTABLE HEARING ON

AVAILABILITY OF CREDIT FOR SMALL BUSINESS

MAY 12, 1993

STATEMENT OF RICHARD RATCLIFFE

Congressman LaFalce and members of the committee, thank you for inviting me to comment about the availability of credit for small business.

A thirty second background on Ratcliffe's Incorporated and myself includes past, present and future time bites. I am Richard Ratcliffe, Chairman of our family retail corporation and I live in Weatherford, Oklahoma. My brother, in Norman, Oklahoma, and my son and I work 10 hour days and most Saturdays at one of the stores. My father started our campus type bookstores and schools supply business in 1925. My brother and I have perpetuated the origional store into eight retail stores in four Oklahoma cities. We have diversified from college textbooks into office products, athletic stores, sheet music, and coffee speciality and biggest of our stores is the medical bookstore at Oklahoma's Health Sciences Campus in Oklahoma City.

We have recently acquired an SBA loan on a new site in Oklahoma City to be completed this July. It is being constructed now. My comments reflect financing for the new building into which we will move our 13 year old business at Health Sciences Campus.

To acquire financing for the new site has tested everyone's ambition. Our credit is excellent and our company has little or no debt depending on the time of year. We wanted a conventional bank loan. As soon as our project was announced, several lenders contacted me offering their bank as a source for funds. Four banks were subsequently given our financial data. We narrowed the field to two and both were SBA lenders. We selected the bank where we knew the most people. We began negotiations on terms and interest. The SBA was required for the terms of a 15 year fixed rate loan.

The negotiations were most complicated when we refused to sign several of the required guarantees. Our attorneys agreed there was too much collateral from the guarantees requested. We capitulated on seveal points but finally refused three of the required items. The bank, the SBA and Ratcliffe's have signed a lesser loan agreement. We were delaying the contractor and have now lost almost one month on our completion date from these negotiations.

I served as Chairman of the Board of Directors for a local bank until last year when regulations from the FDIC convinced me to resign. The FDIC Improvement Act put limits on officers borrowing. The new Improvement Act allows me as a customer/director to retain a lending limit 5 times greater than as an officer (Chairman) of the bank. Ratcliffe's were prohibited by regulations from borrowing the funds from this local bank.

My central comments about borrowing would be that the lenders, whomever they may be, tend to collaterlize the borrower at extreme risk to the borrower. My company has several millions pledged to secure the $600,000.00 SBA guaranteed loan through a SBA certified bank. I knew we were being forced to pledge too much collateral. The banks wanted too many personal guarantees. I complained and tried to move to other lenders to cut the punch list down.

The question is, would I, a bank director, loan discount committee member want to make a business loan with less collateral? No, in fact I probably have cast more no votes on business inventory loans than any other member on the loan committee. And the simple reason is the regulators of our bank will criticize the credit line, perhaps classify it as substandard but if they don't classify it they will for sure list several technical exceptions at the next audit.

To summarize: FIRST- The Committee on Small Business is working on the right problem, "THE AVAILABILITY OF CREDIT TO SMALL BUSINESS". I do not agree Velda Sue will solve the problem in rural America. In my opinion, President Clinton is correct to support less regulated business loans with more emphasis on "character loans".

SECOND- Our size business needs more small loans than large loans. Operating loans help the business survive by providing the funding for the hills and valleys of day to day business. A good Velda Sue loan without operating cash is almost a certain loss. If you fully secure a Velda Sue loan, what will small business have available to collateralize an operating loan?

THIRD- I vote on small business loans every Thursday morning at our loan discount meeting. Very few are good, most are risky and require the banks constant attention, several are refused when first presented and referred to business advisors in our community. I submit to you the availability of credit is there, but, the borrower is subject to too many requirements to secure the loan.

Congressional Subcommittee on Small Business
Round Table on Credit Crunch
May 12, 1993
Chairman Congressman John LaFalce

Presented by Suzanne F. Fairlie, CPC
President, ProSearch, Inc.
Conshohocken, PA 19002

Good morning and Thank you, Mr. Chairman and members of the committee, for the opportunity to share my experiences regarding my declining access to credit as my company became more successful. I speak as a small business owner in the services sector. My purpose this morning is not to present you with solutions - I am not experienced enough in the credit field to begin to do that. After the last two days, I now understand some of the historical rationale behind the current credit crunch issues - but understanding the historical perpective does not alleviate credit needs. Instead, my purpose is to help you understand the repercussions of the existing structures, that make it difficult for small business owners, female or male, who are in the business services sector. My story is personal in nature, not global, but is typical of what other small business owners in service industries are experiencing.

I am the 100% owner of ProSearch Inc., a Sub S Corporation, founded 5 years ago as a permanent placement firm, specializing in high tech personnel to Philadelphia's Fortune 500's - in other words we are headhunters who place computer professionals in companies such as SmithKline, Morgan Bank, ICI America, Dupont. We were recognized locally in our 3rd year as one of the top 25 search firms for the Philadelphia area.

Women owned businesses now employ more than 11 million people, more than the Fortune 500 companies, and yet, we face significantly more difficulties in gaining the access to credit that we need to grow our businesses. Many of these credit problems are because we are in the service industry, as opposed to manufacturing and other areas with inventory. This information has been compiled by the National Foundation of Women Business Owners, and is included in the US Census Bureau Statistics. (Stats compiled from survey conducted from over 1200 members, in 1992)

According to the Foundation statistics, 48% of small business firms are in the business service industry, as I am.

My annual gross sales in 92 were higher than 64% of the other firms surveyed, in the 500,000 to 1 million dollar category. (As a whole, 23% of the firms surveyed produced revenues above $1million.)

ProSearch's gross payroll was well over $300,000, and our increase in sales by more than 20% of the previous year, placed us in the top 25% for firms participating in the survey. ProSearch, and many like it, are major participants in the growth of our economy, in a time when many firms are downsizing, going bankrupt, or just not growing. More important is the fact that in showing a profit for our employees, we are encouraging more spending on goods and services in our country.

To explain my credit problems, let me first say that when I began ProSearch, a business associate offered a loan of $25,000, in exchange for 50% ownership of the company. Not knowing any better, and not knowing where else to turn for start up capital, I agreed. After the first six months, it was clear that ProSearch showed a very strong likelihood of being successful, and in exchange for this loan, at 5% above prime, I was giving away 1/2 of the profits for the rest of my life.. I went to my neighborhood bank, where my husband and I had been doing business for 20 years, showed them my client list, my receivable list, my 20 years history of this business in the computer field in firms such as IBM and Sun Oil.. I explained my financial problem, and this banker took the time to understand the placement industry and who my clients were, and authorized a loan large enough to pay off the friend with interest and bonus, allowing me to regain total ownership of the company -- I now understand this is called a character loan.

In the meantime, I put all the money earned back into the business, to buy start up equipment, office furniture, rent, stationery, and advertising, so that we looked like a strong successful company instead of a small start up of 3. I took almost no salary that year, and we lived on credit cards. These sacrifices were worthwhile because I knew ProSearch would make it if I invested the money earned into the company rather than into my pocket,- the bank later said this had a lot to do with their financing me that first year. However, many women do not have credit card history established at high enough levels to allow them the "privilege" of paying 23% interest on the balances we incurred, or do not have a husband whose salary can pay the basic mortgage and food.

5 months later I again went to the bank for a computer system needed to grow the business, and again showed my receivables which were about 400% of the amount needed), my previous year's financial history, and my client list. The bank approved the loan. In my naivete, I felt very comfortable, because I felt that this established good credit history if I should run into future credit needs. However, this was before my bank was merged, swallowed up, by a much larger bank that was not known for its understanding of small business. During this time, I met with my banker routinely, sent her newspaper clippings about my company, and we got to know each other well, as banker/advisor and client. A year later I ran into a cash flow problem that was only 30 days in duration, but it made me realize the need for a credit line, something I did not have at that point. This time when I went to the bank, they explained that I would need collateral to finance the credit line- the furniture, receivables, and credit history I had accumulated to date were of no value, if there was not hard core collateral.

To many women who have been the sole supporters of their family for years, collateral in the form of real estate or financial instruments is non-existent. I was very fortunate in that I had stocks and bonds saved from my work at IBM and Sun Oil, and so offered these in exchange for the credit line.

Last year, in 1992, the company was now almost 5 years old, had shown a strong record of both growth and credibility, and I had never been late with any payment to any of my vendors. To my surprise, the new banking organization called, and said they would like to meet me to discuss consolidating the two loans (even though one was almost completely paid up and would be paid off in full in less than a year). I was flattered that this large bank wanted to come to my offices, but little did I realize what was about to happen- the bank wanted to change the terms of the loan, and said they would be forced to to call the loan and reissue it as a second mortgage on my house. When I asked why, what had I done wrong, they explained that their new policy was to issue no loans without collateral, and even though the loans were almost paid off, they needed real estate as collateral. I explained that my husband was using the real estate we owned as collateral to expand his offices - he is a psychologist whose office is at home. The banker firmly replied that unless I was willing to use the property as a second mortgage, they would call the loan. I could not ask my husband to stop the construction of his new office expansion, and the bank refused to work with me. Fortunately I found another bank, who was willing to refinance the limited debt i had. In exchange for this, I had to pay prepayment costs on the old loan, pay new points on the new loan with the new bank, and spend weeks researching new banks, during which time I was not contributing to the revenue of my company.

What this means is that banks are not willing to look at the financial history of businesses in the services industries - their receivables record, in order to determine their credit risks. At the time of this situation, I had a receivables list in excess of 400% of the loan, had not experienced one bad debt in the history of the company, and had a 99% of my clients, all repeat clients, always paid their bills within 30 days. Despite this track record, I would have been faced with bankruptcy if I had not found another bank, since I had no other family to go to for finances. We had 2 children in college at the same time, so all savings was earmarked. I don't think the government wants to force succesful business to go under, yet that is exactly what this practice of demanding real estate collateral from service business is doing. even though service industry makes up 48% of our small businesses.

As recently as 5 months ago, I went to the new bank, to request a loan to purchase furniture for expansion. I have now reached the point where we are turning away clients, and the revenue is stable, so that I can justify adding and training 3 more recruiters, and I must give them space to work in. I asked for an SBA loan of $16,000, and they wouldnt talk to me for less than $50,000. When I went to the bank for the money, I heard the same story, that I need real estate collateral, that there is no collateral in my credit history or client base, and so I was forced to go to a leasing company, where the interest rates are almost double.

I am one of the lucky business owners - 5 years later my business is still growing, but due in large part to character loans that are no longer available due to banking regulations, due to the fact that I had already established good credit card history, and because I was married to an understanding husband - to be a successful service business owner, the criteria should not be to marry an understanding spouse. Rather character loans for those business owners who have an established client base and successful credit history, and large receivable base, should be the criteria, to allow this growing sector of the economy to continue growing. If you are really committed to the concept that small business is producing the jobs in this country, please act on your obligation to ensure access to credit for the service sector of small business.

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